LIMITING THE POWER OF SUPERSTAR CEOS

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ABSTRACT

Innovator. Brilliant. Narcissist. Many words have been used to describe Elon Musk. To his devoted fans, he is a visionary, driving the world forward, idolized as the real-life Marvel character Tony Stark. To his critics, he is an unstable egotistical lunatic and needs to be reined in. Love or hate him, there is no doubt that Musk demands attention.

In recent years, a conspicuous trend has emerged wherein "superstar" CEOs, like Musk, have ascended to positions of profound influence and power. These superstar CEOs bring significant benefits to their companies. But their prominence often raises concerns about the concentration of power and potential lack of accountability. Too often, superstar CEOs threaten corporate governance by unduly influencing directors and their ability to faithfully discharge their fiduciary duties. Restricting their power becomes essential in safeguarding corporate governance.

This Article analyzes the danger superstar CEOs pose to the integrity of corporate governance and the pressing need to devise methods to limit their power. This is further exemplified by Elon Musk, who serves as a vivid illustration of a superstar CEO's ability to escape personal liability. Central to this discourse is examining how Directors and Officers (D&O) insurance preserves the essential tenets of the fiduciary duties. However, the exploitation of D&O insurance can hinder directors and officers from realistically meet their fiduciary duties. Ultimately, this Article advocates for expanding state corporate laws to require the use of independent and disinterested insurers, prohibiting directors and officers from personally insuring the companies they serve.

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TABLE OF CONTENTS

Introduction 286
I. Rise of the Superstar CEO & Corporate Law 288
II. The Threat of a Superstar CEO: A Case Example 289
A. The Tweets 290
B. The Breach 293
III. Corporate Governance: Upholding Fiduciary Duties 295
A. The Board and Their Duties 296
1. The Duty of Care 296
a. The Duty of Oversight 297
b. Best interest of the company 298
2. Duty of Loyalty 300
3. Good Faith 302
B. Enforcement of Fiduciary Duties and Personal Liability 303
C. The Role of D&O Insurance 306
1. The Policy 307
2. Premiums and the underwriting process 308
4. D&O Insurance and Corporate Governance 309
IV. An Illustration: Musk's Threat to Corporate Governance 310
A. Board Independence? 311
B. The Board's Potential Breach of Fiduciary Duties 314
1. Lack of Oversight 314
2. Loyalty to Whom? 316
V. Limiting Power in The Absence of Accountability 318
A. Lack of Accountability: Musk "Not Liable" 318
B. The Need for Accountability 320
C. Accountability Mechanisms 321
D. Regulating D&O Insurance 322
Conclusion 325

INTRODUCTION

"Funding secured[1]": Elon Musk tweeting those two words resulted in nearly five years of litigation, multiple Securities and Exchange Commission ("SEC") sanctions, Musk forfeiting his position as Tesla's executive chairman, and both Musk and Tesla paying millions of dollars in fines and legal fees. Yet, by a unanimous verdict, a California jury ruled that Musk was not personally liable for losses caused by his controversial tweet and subsequent actions.

1. *See* section II and accompanying text.

Over the past several years, we have witnessed the rise of "superstar" CEOs and the influence and power they yield. While they can bring significant benefits to their companies, their prominence often raises concerns regarding their concentrated power and potential lack of accountability. Balancing the influence of superstar CEOs with successful corporate governance mechanisms remains an ongoing challenge for boards of directors—who are, after all, required to ensure that their CEOs act in ways that align with corporate policy and corporate law.

Musk is the quintessential "superstar" CEO, described as a "visionary" who's "larger than life."[2] He often pushes the boundaries with his actions resulting in conflicting consequences. Since Musk is a board member and CEO of Tesla, many people wonder how independent the Tesla Board of Directors could possibly be. These worries would only be exacerbated when, in April 2020, Tesla entered an agreement with Musk whereby he would personally provide insurance for Tesla's board members, further questioning their independence.[3] According to SEC filings, Tesla decided not to renew its director and officer liability insurance ("D&O insurance") due to what Tesla claimed as "disproportionately high premiums quoted by insurance companies."[4] Those quoted premiums followed Musk's "funding secured" tweets to take Tesla private.[5]

Considering Musk's behavior and subsequent absence of any personal liability resulting from the harm his behavior inflicted upon Tesla shareholders, this article analyzes the threat superstar CEOs pose to corporate governance. Specifically, this article will examine the Tesla Board of Directors' inability to faithfully discharge their fiduciary duties in the shadow of their superstar CEO—Musk. It highlights the role D&O insurance plays in safeguarding corporate governance and ultimately proposes state action to limit superstar CEOs' influence on the board and their ability to potentially sidestep their fiduciary duties. It proceeds in five parts.

Part I describes the "superstar" CEO and their influence over the corporation and board of directors. Part II provides a practical illustration of superstar CEOs by examining Musk's recent trials and tribulations. Part III explains the importance of fiduciary duties as a fundamental principle of corporate law, how those fiduciary duties can be enforced, and the role of D&O insurance. Part IV illustrates how Musk's actions serve as a prime example of superstar CEOS jeopardizing corporate governance. Part V discusses the lack of accountability superstar CEOs face and the need to rein in their authority. It proposes a method to mitigate superstar CEOs influence on their boards, while advocating for states

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2. Interview by Lesly Stahl with Elon Musk, CEO, Tesla Inc. (Dec. 9, 2018).

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

4. *Id.* (D&O insurance is lability coverage for directors and officers to protect them from claims which may arise from decisions and actions taken (or lack thereof) as part of their duties owed to the corporation.); *see infra* Section III for an in-depth discussion of D&O insurance.

5. *Infra* section II.C.3 and accompanying text.

to amend corporate laws to prohibit directors and officers from personally insuring the companies they serve.

I. RISE OF THE SUPERSTAR CEO & CORPORATE LAW

In recent years, "superstar" CEOs have gained significant fame and influence not only in corporate environments but also in mainstream media, often referred to as "celebrity CEOs."[6] But what makes a CEO a "superstar" CEO? What influence and power do they hold? This section delineates key characteristics that might make a CEO a superstar. It subsequently explores a superstar CEO's significant influence and power over the board of directors.

Superstar CEOs are viewed as holding some charismatic power different from traditional CEOs.[7] Previous studies considered factors that could create a superstar CEO[8] and concluded that no combination of attributes guarantees the making of a superstar CEO.[9] That said, superstar CEOs tend to be individuals who are believed to be "essential to company value."[10] Those who are "essential to company value" are often viewed as innovative thinkers who catapult their companies to incredible success.[11] Investors may believe the CEO is essential to the company's value because they "possesses the idiosyncratic vision that is essential to make the company outperform the competition" or that they possess some exceptional skill or quality that is crucial for carrying out the corporation's vision.[12]

In the media, superstar CEOs are often characterized as brilliant, captivating leaders with the uncanny ability to generate extraordinary financial results for their companies.[13] This is to support the belief that these CEOs are essential to their companies' value. Consequently, these superstar CEOs hold tremendous power over their corporations and their boards. These powers, when unchecked, can wreak havoc on corporate governance.

6. *See generally* RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR 179-85 (Princeton University Press, 2002) (discussing various attributes of charismatic and celebrity CEOs).

7. Assaf Hamdani & Kobi Castiel, *Superstar CEOs and Corporate Law,* 100 Wash U.L. Rev. 1353, 1376 (2023).

8. *See e.g.,* Sydney Finkelstein, *Power in Top Management Teams: Dimensions, Measurement, and Validation*, 35 ACAD. MGMT. J. 505, 509–12 (1992) (some factors included the number of positions CEOs held within the company, whether the CEO was the only insider on the board, and if the CEO was a founder of the company).

9. *Id.* at 524.

10. *See* Hamdani & Castiel, *supra* note 7, at 1394.

11. *Id.*

12. *Id.*

13. *See* Rakesh Khurana, *The Curse of the Superstar CEO*, HARV. BUS. REV. (2002) ("[t]he charismatic CEO was typically—though not invariably—either an entrepreneurial founder or someone who had been brought into the company from the outside. Far from being a predictable organization man, he was expected to offer a vision of a radically different future and to attract and motivate followers for a journey to the new promised land.").

A drawback associated with investors viewing CEOs as superstars who are indispensable to the company's value is that shareholders frequently disregard bad behavior and negative conduct. For example, "when a CEO is perceived as a superstar and the company performs extraordinarily, shareholders are willing to ignore any behavior that might be unacceptable for other CEOs."[14] This evidence does not suggest that shareholders are powerless to influence corporate decisions.[15] Rather, it indicates that shareholders are less inclined to employ their full measure of power to hold superstar CEOs accountable, as shareholders are often in awe of some perceived genius.[16]

A superstar CEO's immense influences on their corporation create a catch-22: In knowing that the shareholders, who elect the board, believe the CEO is crucial to the company's success, why would a board question the decisions of their superstar CEO? What if the superstar CEO is on the board? What if he is also the board chairman?[17] Situations like these are some of the leading causes of corporate governance[18] issues. Simply stated: when the whims of a superstar CEO clash operating a publicly traded corporation, the superstar CEO's inflated power threatens corporate governance, resulting in harm to the corporation's shareholders, officers, and employees alike. We do not need to look hard to find an example of a superstar CEO whose individual volatility caused their company and the board undoubtable distress in its attempt to oversee and control their very own superstar: Elon Musk and the Tesla Corporation.

II. THE THREAT OF A SUPERSTAR CEO: A CASE EXAMPLE

Musk is certainly a model superstar CEO. Tesla admitted the company is "highly dependent" on Musk, that he is essential to the company's value, and without him, Tesla would be negatively impacted.[19] Nevertheless, his tendency

14. Hamdani & Castiel, *supra* note 7, at 1385. (For example, Musk went up for board reelection twice while he had several derivative lawsuits pending against him, including an abuse of power allegation, yet shareholders overwhelmingly – over 90 percent—approved his reelection on the board).

15. *Id*. at 1401.

16. *Id*. at 1402.

17. *See* Thuy-Nga T. Vo, *To Be or Not to Be Both CEO and Board Chair*, 76 BROOK. L. REV. 65, 67 (2010) (concluding that "theoretical arguments and empirical evidence, as reflected in financial and nonfinancial metrics, strongly suggest that a corporate governance structure with a nonexecutive Chair, instead of a dual CEO-Chair, is better suited for the fulfillment of the directors' fundamental responsibilities to oversee business operations and monitor management for the purpose of enhancing shareholder value.").

18. Corporate governance refers to how a corporation is managed and the mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. For a full discussion on defining corporate governance *see* H. Stephen Grace et. al., *The Interplay Between Corporate Governance Issues and Litigation: What Is Corporate Governance and How Does It Affect Litigation?,* BUS. L. TODAY, 1 (2016).

19. *In re Tesla Motors S'holder Litig.,* No. CV 12711-VCS, 2018 WL 1560293, at *16 (Del. Ch. Mar. 28, 2018).

to make impromptu remarks on Twitter[20] has led to undesirable outcomes for Tesla.[21] Section A details two infamous Musk tweets and their consequences for Tesla—from SEC sanctions to nearly five years of shareholder litigation. Section B discusses Musk's failure to comply with the SEC's settlement agreement by continuously tweeting material information without oversight and leading shareholders to file additional lawsuits against Musk and the Tesla board of directors.

A. The Tweets

On Aug. 7, 2018, Musk tweeted about the idea of taking Tesla private, posting on Twitter: "Am considering taking Tesla private at $420. Funding secured."[22] Musk's subsequent tweets expressed his commitment to safeguard the interests of current shareholders, voicing his desire for them to remain invested in Tesla even if it transitioned to a private company.[23] Musk then tweeted: "Investor support is confirmed. Only reason why this is not certain is that it's contingent on a shareholder vote."[24]

This series of tweets led to market instability and regulatory scrutiny. As represented in the graph below, immediately following the tweets, Tesla's share price jumped up 11 percent to $379.57.[25] At the time, this was just below Tesla's

20. As of July 2023, the social media/platform named "Twitter" was renamed "X." At all times relevant to this Article, the company was named "Twitter" and thus, this Article will refer to the company as "Twitter."

21. Elon Musk (@elonmusk), TWITTER (Jan. 31, 2020, 1:12 AM PDT), https://twitter.com/elonmusk/status/1223172311546724352?s=20 (In addition to the tweets discussed in this section: In January 2020, Musk compared COVID-19 to the common flu, downplaying the severity of the virus. He also made tweets suggesting that children were "essentially immune" to COVID-19, contradicting public health guidance). *See* Clare Duffy, *Elon Musk rails against stay-at-home orders while tweetingD dbunked by controversial coronavirus claims,* CNN BUSINESS (Apr. 30, 2020, 6:37 PM EDT), https://www.cnn.com/2020/04/29/tech/elon-musk-twitter-coronavirus/index.html. (In 2018, he called a cave diver involved in the Thai cave rescue operation a "pedo guy" on Twitter, which led the cave diver to file a defamation suit against Musk). *See* Niraj Chokshi, *Elon Musk Sued by Cave Rescuer He Accused of Being a Pedophile,* N.Y. TIMES (Sept. 17, 2018), https://www.nytimes.com/2018/09/17/business/elon-musk-sued-pedophilia-accusation.html. In May 2021, Musk announced on Twitter that Tesla would no longer accept Bitcoin as payment for Tesla vehicles. Elon Musk (@elonmusk), TWITTER (May 12, 2021, 3:06 PM PDT), https://twitter.com/elonmusk/status/1392602041025843203. This caused a significant decline in the cryptocurrency's value. Rishi Iyengar, *Bitcoin Plunges 12% After Elon Musk Tweets That Tesla Will Not Accept it as Payment,* CNN BUSINESS (May 13, 2021, 9:43 AM EDT), https://www.cnn.com/2021/05/12/tech/elon-musk-tesla-bitcoin/index.html. Similarly, his tweets about other cryptocurrencies have led to significance market fluctuations. *See generally* Lennart Ante, *How Elon Musk's Twitter Activity Moves Cryptocurrency Markets,* BLOCKCHAIN RESEARCH LAB, Jan. 12, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstractid=3778844.

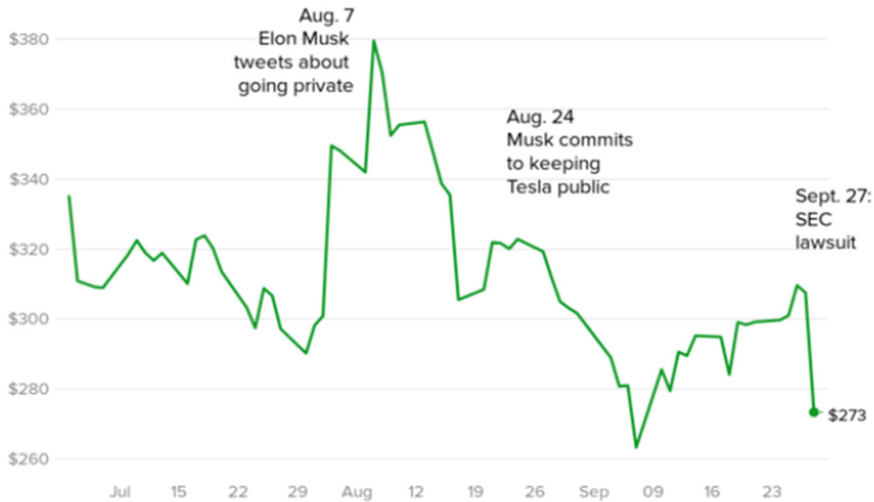
22. Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 9:48 AM), https://twitter.com/elonmusk/status/1026872652290379776?lang=en.

23. *See generally,* Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018), https://twitter.com/elonmusk/status/1026872652290379776?lang=en.

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

25. Neal E. Boudette & Matt Phillips, *Elon Musk Says Tesla May Go Private, and Its Stock Soars,* N.Y. TIMES (Aug. 7, 2018), https://www.nytimes.com/2018/08/07/business/tesla-stock-elon-musk-private.html.

all time high share price.[26] In the following weeks, the share price tumbled after the proposal fell apart.[27] In less than two month following the tweet, Tesla's market value fell $19.6 billion, plummeting more than 30 percent.[28]



Source: *The New York Times*[29]

In response, the SEC filed complaints against Musk[30] and Tesla.[31] The SEC's complaint alleged that Musk's tweets on August 7, 2018 regarding taking Tesla private were false and misleading in violation of Section 10b and Rule 10b-5 of the 1934 Securities Exchange Act.[32] According to the SEC, Musk was aware of

26. Alexandria Sage & Sonam Rai, *Elon Musk Says Taking Tesla Private is 'Best Path', Shares Up,* REUTERS (Aug. 7, 2018, 10:01 AM), https://www.reuters.com/article/us-tesla-musk/elon-musk-says-taking-tesla-private-is-best-path-shares-jump-idUSKBN1KS1WM.

27. 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.

28. Kate Gibson, *Elon Musk's "Taking Tesla Private" Erased nearly $20 Billion of Company's Value,* CBS NEWS (Sept. 28, 2018, 12:44 PM), https://www.cbsnews.com/news/elon-musks-taking-tesla-private-funding-secured-tweet-erased-20-billion-of-companys-value/.

29. Id.

30. *See U.S. Sec. & Exch. Comm'n v. Musk*, No. 1:18-cv-8865 (S.D.N.Y 2018).

31. *See U.S. Sec. & Exch. Comm'n v. Tesla, Inc.,* No. 1:18-cv-8947 (S.D.N.Y 2018).

32. Press Release, U.S. Sec. & Exch. Comm'n (Feb. 26, 2018), https://www.sec.gov/news/press-release/2018-226; 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5. Section 10b and Rule 10b-5 seek to regulate and mandate certain disclosure by firms which sell securities. Section 10b and Rule 10b-5 prohibit disclosure of false or misleading information, and that information has to be material. "Material information" was not defined until 1976, when the Court resolved the issue in *TSC Industries v. Northway, Inc*., 426 U.S. 438 (1976). 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." *Id.* at 449. This was generally understood to include information that significantly affected a company's financial performance and consequently translated into stock market gains or losses. *See* Karen E. Woody, *Conflict Minerals Regulation: The SEC's New Role As Diplomatic and Humanitarian Watchdog,* 81 FORDHAM L. REV. 1315, 1322-24 (2012) ("In 1988, the Supreme Court reaffirmed this

the uncertainty surrounding the potential transaction, as it was subject to numerous contingencies.[33] The SEC explained that "Musk did not discuss specific deal terms, including price, with any potential financing partners, and his statements about the possible transaction lacked a factual basis. . . . [I]n truth, Musk knew that the potential transaction was uncertain and subject to numerous contingencies."[34] Further, according to the SEC, the price quoted by Musk lacked substantive valuation, rather "Musk had arrived at the price of $420 by assuming a 20 percent premium of what Tesla's then-existing share price [was], and then rounding up to $420 because of the significance of that number in marijuana culture, and his belief that his girlfriend would be amused by it."[35] In addition, the SEC claimed that Musk's false and misleading tweets triggered Tesla's stock price to jump on August 7, 2018, leading to significant market disruption and confusion.[36]

The SEC's complaint against Tesla alleged that despite the company informing the public in 2013 that Musk's Twitter account would be used to announce material information regarding Tesla and urging investors to review Musk's tweets, Tesla lacked an adequate process for overseeing and verifying the accuracy of Musk's tweets.[37] Furthermore, Tesla did not establish any disclosure controls or procedures in place to assess whether the information conveyed in Musk's tweets necessitated disclosure in the company's SEC filings.[38]

Consequently, Musk and Tesla settled with the SEC without admitting or denying the allegations.[39] The settlement required Musk to step down as Tesla's Chairman for three years[40] and pay $20 million in penalties.[41] Tesla was required

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materiality standard in *Basic, Inc. v. Levinson,* and unanimously held that a bright-line rule regarding what information is considered material is inappropriate and unnecessary. The Court stated that materiality is … 'about what is important to investors, nothing more and nothing less.' Specifically, 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." *Id.* at 1323. 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.

33. Press Release, U.S. Sec. & Exch. Comm'n (Feb. 26, 2018), https://www.sec.gov/news/press-release/2018-226.

34. *Id*.

35. CNBC Television, *Tesla's Elon Musk Sued by SEC for Fraud – Thursday, Sept. 27 2018*, YOUTUBE (Sept. 27, 2018), https://www.youtube.com/watch?v=kJzed7DQdGs&t=323s.

36. Press Release, U.S. Sec. & Exch. Comm'n (Feb. 26, 2018), https://www.sec.gov/news/press-release/2018-226.

37. Complaint at ¶36-37, *U.S. Sec. & Exch. Comm'n v. Tesla, Inc.*, No. 1:18-cv-8947 (S.D.N.Y 2018).

38. *Id*.

39. Press Release, U.S. Sec. & Exch. Comm'n (Feb. 26, 2018), https://www.sec.gov/news/press-release/2018-226.

40. *See* Dana Hull & Ben Bain, *Elon Musk Steps Down as Tesla Chairman in $40 Million SEC Settlement,* TIME (Sept. 30, 2018), https://news.yahoo.com/news/elon-musk-steps-down-tesla-134021468.html. Elon was allowed to remain CEO and a director of Tesla during this time.

41. Consent Motion for Entry of Final Judgment, *U.S. Sec. & Exch. Comm'n v. Musk*, No. 1:18-cv-8865 (S.D.N.Y. Oct. 16, 2018). *See also* Mathew Goldstein, *Elon Musk Steps Down as Chairman in Deal*

to appoint additional independent directors and pay $20 million in penalties.[42] Additionally, Musk and Tesla agreed to form a board committee responsible for setting controls and overseeing Musk's public communications about Tesla.[43] The final settlement required Tesla to:

> [I]mplement mandatory procedures and controls to oversee all of Elon Musk's communications regarding the Company made in any format, including, but not limited to, posts on social media (*e.g.*, Twitter), the Company's website (*e.g.,* the Company's blog), press releases, and investor calls, and to pre-approve any such written communications that contain, or reasonably could contain, information material to the Company or its shareholders. The definition of, and the process to determine, which of Elon Musk's communications contain, or reasonably could contain, information material to the Company or its shareholders shall be set forth in the Company's disclosure policies and procedures . . . .[44]

The terms required Musk to seek "pre-approval of any such written communications that contain, or reasonably could contain, information *material* to the Company or its shareholders."[45] Thus, if Musk were to tweet something that had the potential to impact Tesla's stock, he was obligated to obtain preapproval from a designated in-house securities lawyer.

Musk's tweets on August 7, 2018, and subsequent SEC sanctions caused dissatisfaction among Tesla shareholders. In August 2018, a class action lawsuit was filed against Tesla and Musk individually in the Northern District of California (hereinafter referred to as the "funding secured" derivative litigation). Thereafter, between October and November 2018, five derivative lawsuits were filed against Musk and other members of the board.[46]

B. The Breach

As many could have predicted, Musk continued tweeting material information regarding Tesla without approval—leading to additional lawsuits brought against Musk and Tesla. Just five months after the SEC settlement, on February 19, 2019, Musk tweeted that Tesla would "make around 500K"[47] cars in 2019, which contradicted Tesla's official guidance of 360,000 to 400,000 cars in 2019.[48]

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.

42. *Id*.

43. Goldstein, *supra* note 41.

44. Consent of Defendant Tesla, Inc., U.S. Sec. & Exch. Comm'n v. Musk, No. 1:18-cv-8865, ¶ 6(d) (S.D.N.Y. Sept. 29, 2018).

45. *Id*. ¶ 6(d) and (c) (emphasis added).

46. Tesla, Inc., Annual Report (Form 10-K) (2018).

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

48. *See* Neal E. Boudette, *Tesla's Record Deliveries Aren't Enough for* Investors, N.Y. TIMES (Oct. 2, 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 (Oct. 23, 2019),

Musk's tweet prompted the SEC to file a motion to hold him in contempt for violating the settlement.[49] Musk argued he only needed preapproval if the tweets were material, and that he was free to determine whether his tweets were material.[50] Musk's contentions led to an amendment of the original SEC settlement agreement to include specific topics requiring oversight and pre-approval of Tesla's securities lawyers.[51] The amended settlement left some room for the board to determine what additional topics needed oversight – covering any "other topics that [Tesla] or the majority of the independent members of its Board of Directors may request, if it or they believe pre-approval of communications regarding such additional topics would protect the interests of the Company's shareholders . . . ."[52]

Despite the SEC's efforts, Musk continued to post erratic tweets pertaining to Tesla. For example, on May 1, 2020, Musk suggested that Tesla's stock was overvalued, tweeting: "Tesla stock price is too high imo [in my opinion]."[53] Immediately prior to the tweet, Tesla's stock price was $761.31.[54] In the hours following Musk's tweet, Tesla's stock price dropped 9.7 percent to $686.93, equivalent to a loss of "almost $14 billion in market capitalization."[55]

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https://www.nytimes.com/2019/10/23/business/tesla-earnings.html (reporting that in 2019 Tesla forecasted that it would sell 360,000 – 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).

49. 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.

50. 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, 4:04 PM PDT), https://www.theverge.com/2019/3/22/18277919/elon-musk-sec-court-contempt-twitter.

51. These topics included: "the Company's financial condition, statements, or results, including earnings or guidance; potential or proposed mergers, acquisitions, dispositions, tender offers, or joint ventures; production numbers or sales or delivery numbers (whether actual, forecasted, or projected) that have not been previously published via pre-approved written communications issued by the Company ("Official Company Guidance") or deviate from previously published Official Company Guidance; new or proposed business lines that are unrelated to then-existing business lines (presently includes vehicles, transportation, and sustainable energy products); projection, forecast, or estimate numbers regarding the Company's business that have not been previously published in Official Company Guidance or deviate from previously published Official Company Guidance; events regarding the Company's securities (including Musk's acquisition or disposition of the Company's securities), credit facilities, or financing or lending arrangements; nonpublic legal or regulatory findings or decisions; any event requiring the filing of a Form 8-K by the Company with the Securities and Exchange Commission, including: a change in control; or a change in the Company's directors; any principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, or any named executive officer; or such other topics as the Company or the majority of the independent members of its Board of Directors may request, if it or they believe pre-approval of communications regarding such additional topics would protect the interests of the Company's shareholders[.]" Consent Motion for Entry of Final Judgment, *U.S. Sec. & Exch. Comm'n v. Musk*, No. 1:18-cv-08947-AJN ¶ 7 (S.D.N.Y. Apr. 26, 2019).

52. *Id.*

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

54. *Gharrity v. Musk*, No. 2021-0199-JRS ¶ 30 (Del. Ch. Mar. 11, 2021).

55. *Id.*

As a result of Musk's continuous erratic posts, a derivative lawsuit was filed against Musk in March 2021 for violating his fiduciary duties to Tesla by continuously violating the SEC settlement.[56] The complaint also alleged that Tesla board members violated their fiduciary duties to the company.[57] According to the complaint, even after Musk breached the SEC settlement, the board failed to impose meaningful restrictions: "at all relevant times the Board was on explicit notice that they were failing in their duties . . . ."[58] As explained in the complaint, "the Board failed to oversee Musk" "breaching their fiduciary duties, and subjecting Tesla to further damages as a result of those violations."[59] Further, the complaint alleged that "the Tesla Board is incapable of making an independent and disinterested decision" and had "consistently proven itself to be incapable of preventing Musk from continuing his unlawful and damaging tweets."[60]

The actions against Musk and Tesla were the result of poor corporate governance. To ensure strong corporate governance, boards must maintain independence and put the company's interests first. To understand the full implication of the allegations against Musk and Tesla, we must examine one of the fundamental corporate law principles: fiduciary duties.

III. CORPORATE GOVERNANCE: UPHOLDING FIDUCIARY DUTIES

One of the primary goals of corporate and securities liability law is to deter corporate fiduciaries from engaging in harmful conduct to the company and shareholders; in other words, to promote good corporate governance. The concept of corporate governance is easily understood on its face—because the board of directors hold all the corporate powers, the business and affairs of the corporation shall be managed by the board or under the board's direction and subject to its oversight.[61] However, the laws that structure governance roles can be complex.

Section A explores the crucial role the board of directors play in corporate governance and the fiduciary duties they must uphold: the duty of care and the duty of loyalty. It further details the many mechanisms in place to protect directors and officers from personal liability. Section B explains how derivative suits act as a means for shareholders to hold directors and officers liable. Section C expounds on the substantial personal financial risk directors face in derivative suits, which leads companies to take out D&O insurance to protect their directors and officers. However, the protection afforded by D&O insurance comes with costs, as reflected by the policy premiums added to D&O insurance. These

56. *Id.* at ¶ 1.
57. *Id*.
58. *Id*. at ¶ 249 and ¶ 250.
59. *Id*. at ¶ 319.
60. *Id.* at ¶ 236
61. MODEL BUS. CORP. ACT §8.01(b) (2023)

premiums often reflect the health of a company's corporate governance, including issues a board may have in overseeing a superstar CEO.

A. The Board and Their Duties

The board of directors plays an important role in corporate governance, providing oversight, guidance, and strategic direction to a company.[62] They are responsible for establishing policies and procedures to ensure the company operates within legal and ethical boundaries.[63] In fulfilling this role, boards are responsible for appointing the CEO and other officers.[64] As members of management, these board-appointed officers are then responsible for the day-to-day operation of the company.[65] Although the board does not manage the corporation's daily operations, they provide guidance and support to the CEO while maintaining oversight and accountability for the CEO's actions. Because of their critical roles, both officers and directors owe fiduciary duties to their companies. Thus, officers and directors are referred to as corporate fiduciaries. Corporate fiduciaries have two broad fiduciary duties they must discharge in good faith: the duty of care and the duty of loyalty.[66]

1. The Duty of Care

The duty of care for corporate fiduciaries is a fundamental principle of corporate governance. The concept of the duty of care was established through common law and continues to evolve.[67] The basic requirement of the duty of care is to exercise "reasonable skill, diligence, and care when making business decisions."[68] Most states have codified the fiduciary duty of care in state statutes.

62. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 599-600 (2003) (discussing the role of the board); *see also Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) ("The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors." (citing 8 Del. C. § 141(a))).

63. Ian Warner, *What are the Roles and Responsibilities of the Board of Directors?*, APRIO (July 14, 2021), https://aprioboardportal.com/news/what-are-the-roles-and-responsibilities-of-the-board-of-directors/.

64. Mike Boland & Don Hofstrand, *The Role of Board of Directors*, IOWA STATE UNI. EXTENSION AND OUTREACH (Nov. 2021), https://www.extension.iastate.edu/agdm/wholefarm/pdf/c5-71.pdf.

65. *Id.*

66. *See Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) ("In performing their duties the directors owe fundamental fiduciary duties of loyalty and care."). These duties originated under common law but many states have codified some of the requirements. For example, MBCA 8.30(a) (2016) requires directors to act "(i) in food faith, and (ii) in a manner that directors reasonable believes is in the best interest of the corporation."

67. *See generally* Angela N. Aneiros & Karen E. Woody, *Caremark's Butterfly Effect*, 72 AM. U.L. REV. 719, 734-40 (2023) (providing a detailed account of how *Caremark* duties have evolved).

68. *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).

The Model Business Corporation Act ("MBCA") requires that directors "shall discharge their duties with care that a person in a like position would reasonably believe appropriate under similar circumstances."[69]

The duty of care applies to directors whenever they need to become "informed in connection with their decision-making function or devoting attention to their oversight function."[70] This corresponds with the two responsibilities directors have under the duty of care: (1) overseeing the company's management to ensure they are adhering to legal and ethical standards in the best interest of the company and (2) making decisions in the best interest of the company.[71]

a. The Duty of Oversight

A director's obligation to oversee what others do is known by several different terms: the "duty to monitor," the "duty of oversight," "oversight duties," or "*Caremark* duties."[72] These duties are one in the same and require fiduciaries to actively monitor the company's operations and investigate corporate misconduct where it is reasonable. For example, if someone reports sexual harassment to management, oversight duties require management to investigate.[73]

Under *Caremark* duties, the board must establish monitoring mechanisms aimed at evaluating corporate compliance. In doing so, directors[74] must (i) make

69. MODEL BUS. CORP. ACT § 8.30(b) (AM. BAR ASS'N 2023).

70. *Id.*

71. *See Id.*§ 8.01; § 8.01 cmt.

72. Dubbed after one of Delaware's most significant duty of care cases. *See In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996), adopted by *Stone v. Ritter*, 911 A.2d 362, 365 (Del. 2006). In *Caremark,* the defendant company Caremark International was involved in a kickback scheme related to Medicare and Medicaid payments in exchange for doctor referrals. The firm eventually had to pay a landmark settlement to both federal and state regulators, as well as over $85 million in restitution. As a result, shareholder-plaintiffs 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." 698 A.2d at 967. 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 . . ." *Id.* at 970. 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." *Id. See also,* Angela N. Aneiros & Karen Woody, *How a "Superstar" CEO Exposes the Necessity for Third party D&O Insurance,* 53 Stetson L. Rev. 265 (2024).

73. *See generally, In re McDonald's Corp. S'holder Derivative Litig.,* 289 A.3d 343, 361 (Del. Ch. 2023) ("Corporate fiduciaries who are aware of harassment but fail to react, or who affirmatively enable harassment to continue, may be sued for breach of the duties of care and loyalty." *Id.* at 376.).

74. Recently, on January 25, 2023, Vice Chancellor Travis Laster of the Delaware Court of Chancery clarified with certainty that "corporate officers owe a duty of oversight" and further, it applied "equally, if not to a greater degree, to officers" than to directors. *Id* at 349. While the duty of oversight has evolved since the 1996 *Caremark* opinion, it was never implicitly stated that this duty extended to officers. (For a detailed explanation of the evolution of *Caremark see generally* Aneiros & Woody, *supra* note 67). Corporate attorneys were quick to discuss the significant implication of the opinion. Yet, as stated by the court, "[t]he Delaware Supreme Court has held that under Delaware law, corporate officers owed the same

a good faith effort to ensure the corporation has implemented a proper reporting system, and (ii) appropriately address "red flags" of corporate wrongdoing.[75] Relevant and timely information is essential to discharge the board's supervisory and monitoring role. However, "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[76] In other words, directors do not need to look for misconduct, but if there are some reasons to believe misconduct may be happening (a "red flag") they cannot look the other way.

To strengthen the monitoring function of the board, ideally, the board is comprised of both inside and outside directors.[77] An independent board member is a non-employee and often called an "outside" director. Independent boards are believed to foster less biased decision making, mitigate their conflicts of interest, and overall uphold the best interest of the shareholders. Notably, an "inside" director is often viewed as having an advisory-focused role, while an independent director is a monitory-oriented role.[78]

b. Best interest of the company

As the corporation's ultimate decision makers, directors must make decisions in the best interest of the business. Yet sometimes a business decision turns out poorly. To facilitate risk taking and encourage individuals to serve on boards, the business judgment rule protects directors' business decisions.[79] The business judgment rule holds that a director will not be held liable even if their decision turns out to be disastrous for the company.

In applying the business judgment rule, courts will presume that in making business decisions, directors "acted on an informed basis, in good faith and in

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fiduciary duties as corporate directors, which logically includes the duty of oversight." *See generally, In re McDonald's Corp.,* 289 A.3d at 349-50.

75. *Stone*, 911 A.2d at 369.

76. *Graham v. Allis-Chalmers Mfg. Co.,* 188 A.2d 125, 130 (Del. 1963).

77. *See* Cheryl L. Wade, *What Independent Directors Should Expect from Inside Directors: Smith v. Van Gorkom as a Guide to Intra-Firm Governance*, 45 WASHBURN. L. J. 367, 373 (2006) (explaining the importance of both inside and outside directors to ensuring that the corporation's officers and directors successfully execute on their fiduciary duties).

78. Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for A Board Suite,* 2017 WIS. L. REV. 19, 27 (2017).

79. 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." Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. COPR. L. 405, 411 (2013) (*quoting Parnes v. Bally Ent. Corp*., 722 A.2d 1243, 1246 (Del. 1999); *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984). The business judgment rule is a principle of judicial review—rather than a rule of conduct—under which courts grant the decisions of corporate directors greater deference. Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 344 (2005).

the honest belief that the action taken was in the best interests of the company."[80] In practice, the business judgment rule ensures that directors are immune from most negligence suits, only being held liable for the act amounting to "gross negligence."[81] Directors are entitled to the protection of the business judgment rule so long as their decisions are made in good faith and are (1) not self-interested (not a breach of loyalty claim), (2) informed to the extent reasonably appropriate (duty of oversight), and (3) rational believe that the decision was in the best interest of the corporation.[82]

Most states throughout the country include a mechanism to protect corporate fiduciaries from personal liability through state exculpatory statutes, also known as "raincoat provisions."[83] These statutes permit corporations to limit or eliminate corporate fiduciaries' personal monetary liability for claims that the fiduciary breached their duty of care by acting negligently or recklessly.[84]

There are exceptions and logistical necessities required before directors and officers may be exculpated. In Delaware, in order for corporate fiduciary to effectively be exculpated, the corporation must include the necessary raincoat provision in the corporation's certificate of incorporation.[85] Seeking to adopt

80. *Aronson,* 734 A.2d at 812. *See also* Lyman Q. Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose,* 38 Del. J. Corp. L. 405, 427 (2013).

81. There are no specific acts (or non-actions) that automatically equates to "gross negligence" In *Smith v. Van Gorkom*, the court concluded that the directors were grossly negligent in failing to inform themselves of the value of the company and of the proposed transaction. 488 A.2d 858, 874 (Del. 1985).

82. *See In re Trados Inc. S'holder Litig.,* 73 A.3d 17, 43 (Del. Ch. 2013) ("[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."); *see also* Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers,* 117 COLUM. L. REV. 1075, 1144 (2017) ("[T]he board (or controlling shareholders) receives protection under the business judgment rule only to the extent that it is independent and free of influence from materially conflicted parties.").

83. *See e.g.* MODEL BUS. CORP. ACT § 2.02(b)(4) (2021). Many states model their director shield language after MBCA § 2.02(b)(4), including: Arizona, Colorado, the District of Columbia, Hawaii, Idaho, Iowa, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, South Dakota, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. *See* Mathew Gerard Dore, *Raincoat or Slicker Suit? An MBCA Director Shield Keeps Board Members Dry in a Going Private Merger,* American Bar Association (Jul. 13, 2022), https://www.americanbar.org/groups/businesslaw/resources/business-law-today/2022-july/raincoat-or-slicker-suit/. IOWA CODE § 490.202(2)(d).

84. Historically, exculpation was allowed for directors only and was not available to officers. As a matter of policy, exculpation of officers appeared to be inappropriate. Having direct management roles within the day-to-day operation of the corporation, officers have a direct oversight role. Nevertheless, in August 2022, the governor of Delaware signed into law amendments to the General Corporation Law of the State of Delaware (DGCL). The amendments to Section 102(b)(7) permits a corporation to limit the personal liability of *both* directors and officers, including the president, CEO, COO, CFO, chief legal officer, controller, treasurer, chief accounting officers, and others "identified in the corporation's public filings with the SEC" or who have consented through a written agreement to accept service of process on the corporation's behalf. DEL. CODE ANN. tit. 8, §102(b)(7).

85. *See* § 10:8. Statutory developments limiting directors' liability for duty-of-care violations; officer exculpatory provisions, 2 Treatise on the Law of Corporations § 10:8 (3d); *see also* Aaron Wendt and Brianna Castro, *What to Watch for in Proxy Season 2023: Officer Exculpation*, Harvard Law School Forum on Corporate Governance (Apr. 18, 2023). https://corpgov.law.harvard.edu/2023/04/18/what-to-watch-for-in-proxy-season-2023-officer-exculpation/ ("Under Section 102(b)(7), a corporation must

officer exculpation provisions would require amending the certificate of incorporation.[86] To do so, the company would need to seek shareholder approval.[87]

Exculpatory statutes have their limits. They do not permit exculpation for claims brought by or in the right of the corporation, including claims brought derivatively by shareholders on behalf of the corporation.[88] They also prohibit the exculpation of corporate fiduciaries for (1) breaches of the fiduciary duty of loyalty, (2) failure to act in good faith, and (3) transactions where an officer derives an improper personal benefit.[89] For these reasons, for a plaintiff to bring a suit on behalf of the corporation to hold a director or officer (such as a superstar CEO) accountable, they must allege that they acted in bad faith or breached their duty of loyalty.[90]

2. *Duty of Loyalty*

The duty of loyalty broadly requires corporate fiduciaries to place the interest of the company before their personal interests.[91] Corporate fiduciaries "are not permitted to use their position of trust and confidence to further their private interests."[92] The duty of loyalty imposes a duty to avoid conflicts of interest.[93] There are two broad categories of this type of conduct: (1) interested transactions and (2) corporate opportunity transactions.[94]

The general idea of an interested transaction is that a conflict exists where a corporate fiduciary is on both sides of the transaction: for example, if a director

affirmatively elect to include an exculpation provision in its certificate of incorporation."). *See also* DEL. CODE ANN. tit. 8, §102(b) (West 2022).

86. DEL. CODE ANN. tit. 8, §242(b)(1) (West 2023). According to §242(b)(1), a majority of the outstanding voting power of a corporation's capital stock must approve an amendment to its charter.

87. Therefore, the board cannot exempt fiduciaries simply by amending the bylaws or through a resolution. §242(b)(1), provides several examples of what type of actions require a shareholder vote, including that a corporation may "amend its certificate of incorporation, from to time" in any way the corporation wants, so long as the shareholders have the opportunity to vote on the matter. *See id.*

88. DEL. CODE ANN. tit. 8, §102(b)(7) (West 2022).

89. *Id*.

90. *See In re Walt Disney Co. Derivative Litig.,* 906 A.2d 27, at 52 (Del. 2006).

91. *See* Denise M. Alter, *Corporate Art Collecting and Fiduciary Duties to Shareholders: Legal Duties and Best Practices for Directors and Officers*, COLUM. BUS. L. REV. 1, 8 n.18 (2009) (noting the duty of loyalty involves "avoiding acting in a self-interested manner to the corporation's detriment . . . .").

92. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

93. *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 interests. Directors are supposed to act in the interest of their corporation and its shareholders, rather than their own interests.").

94. The interested transaction category of duty of loyalty cases "arise[s] out of transactions between the corporation and the 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 their own if the opportunity meets a four-pronged test devised in *Guth v. Loft, Inc*. 5 A.2d 503, 509 (Del.1939). *Broz v. Cellular Info. Sys., Inc.,* 673 A.2d 148, 150, 155 (Del. 1996).

contracts with another company that they own, they have a conflict of interest.[95] Not all interested transactions constitute a breach of the duty of loyalty. How an interested transaction is treated by courts depends on the ownership structure and whether there is a controlling shareholder.[96]

If an interested transaction does not involve a controlling shareholder, the courts will look at whether a majority of the company's directors who voted for the transaction are independent and disinterested to determine if there was a breach of the duty of loyalty.[97] If so, the court will apply the business judgment rule.[98] 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."[99] In other words, when directors and officers make business decisions, even when they turn out to be poor 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.

If the transaction concerns a controlling shareholder, the board must implement specific protective measures to rely on the business judgment rule to shield them, otherwise, the transaction is scrutinized under the "intrinsic fairness" doctrine (also called the "entire fairness" doctrine).[100] Under the intrinsic fairness doctrine, the corporate fiduciary must show that (1) the *process* of entering the deal was fair to the company and (2) the *substantive terms* of the deal were fair to the company.[101] If the transaction passes the intrinsic fairness test, there will be no personal liability on the corporate fiduciaries.

Further, most states have adopted "safe harbor" statutes to protect officers and directors from liability when it involves an interested transaction, as long as they meet the statute's requirements.[102] Under such statutes, if a corporate

95. *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).

96. Generally, a controlling shareholder is one that holds more than 50% of the voting power in a corporation. However, there have been recent departures from this generalization. A Delaware court treated Musk as a controlling shareholder for purposes of reviewing an interested transaction, despite Musk only holding 22% of the Tesla's voting rights at the time. *See In re Tesla Motors, Inc. S'holder Litig.,* No. 12711-VCS, 2018 WL 1560293, at *1-2 (Del. Ch. Mar. 28, 2018) (The court assumed without deciding that the Musk was a controlling stockholder and that a majority of the Company's Board was conflicted. "[T]he Complaint pleads sufficient facts to support a reasonable inference that Musk exercised his influence as a controlling stockholder with respect to the Acquisition." *Id.* at *19.)

97. *Aronson v. Lewis,* 473 A.2d at 812.

98. *Id.*

99. *Id.*

100. *See Kahn v. M&F Worldwide Corp. (MFW),* 88 A.3d 635 (Del. 2014), as modified by *Flood v. Synutra, Int'l, Inc.,* 195 A.3d 754 (Del. 2018).

101. *See* Velasco, *supra* note 93, at 1047, 1054–55 (stating that not all conflicted transactions will arise to the level that the conflict must be evaluated under the entire fairness standard).

102. *See e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2022); CAL. CORP. CODE § 204(a)(10) (West 2022); N.Y. BUS. CORP. LAW § 719 (McKinney 2016); TEX. BUS. ORGS. CODE ANN. § 21.418(b) (West

fiduciary is involved in an interested transaction, the transaction may be "ratified" in several ways. An interested transaction will not be void or voidable if (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 an affirmative vote of a majority of the disinterested directors, or (2) the material facts of the interested transaction are disclosed or known to the stockholders entitled to vote and is approved in good faith by vote of the stockholders.[103]

Once ratified by the board or shareholders, states differ on whether the transaction can still be subjected to litigation. Many states, including Delaware, provide that if the transaction was ratified, a court may still review the transaction under the intrinsic fairness test.[104] Conversely, the newer version of the MBCA, adopted by some states, allows approval of the majority of the disinterested directors or the majority of the shareholders to "sanitize" the deal without consideration of the underlying fairness of the deal.[105] Thus, the transaction is shielded from litigation and shareholders cannot attempt to void the transaction.

3. Good Faith

Fiduciaries must always act in good faith in carrying out their fiduciary duties to receive immunity from liability.[106] Defining good faith is not always easy. Courts often opt to define what constitutes *bad faith*. For example, in *Disney*, the court explained:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the

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2011); NEV. REV. STAT. ANN. § 78.138.7 (West 2021); FLA. STAT. ANN § 607.0831 (West 2020); 805 ILL. COMP. STAT. ANN. 5/8.65(c) (2015); GA. CODE ANN. § 14-2-864(c) (West 2010); MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(e) (West 2016); N.J. STAT. ANN. § 14A:6-12 (West 1974); 15 PA. STAT. & CONS. STAT. ANN. § 1735 (West 2023).

103. DEL. CODE ANN. tit. 8, § 144 (West 2010); *see, e.g., Solomon v. Armstrong*, 747 A.2d 1098, 1113–1116 (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).

104. *See Kahn v. Lynch Communication Systems*, 638 A.2d 1110,1116-17 (Del. 1994); *see also* DEL. CODE ANN. tit. 8, § 144 (West 2010); *see also* MBCA §8.31 (1975) (which supports a court's ability to still determine whether the transaction was fair even after the deal was approved by the majority of disinterested directors or shareholders).

105. *See* MBCA § 8.61(b) (2016) (providing that self-dealing may not be the subject of a suit by or on behalf the corporation if the deal was approved under § 8.62 (director approval) or § 8.63 (shareholder approval)).

106. Courts have historically referred to "a triad of fiduciary duties" to include the duty of care, duty of loyalty, and good faith. *See Van Gorkom*, 488 A.2d 858, 872 (Del. 1985; *Aronson v. Lewis,* 473 A.2d 805, at 812 (Del. 1984); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998). However, good faith is not necessarily treated as a separate duty, but an overarching requirement in carrying out either duty of care or duty of loyalty. Delaware has clarified that good faith is not a separate duty, but an "obligation" that is part of the duty of loyalty. *Stone ex rel. AmSouth Bancorporation v. Ritter,* 911 A.2d 362, 370 (Del. 2006). "Where directors fail to act in the face of a known duty to act [breach of duty of care], thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id.* at 370.

> fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.[107]

Thus, good faith requires the fiduciary to act in the best interest of the corporation so long as it is within legal parameters."[108]

Significantly, statutes intended to avoid director and officer liability, such as exculpatory clauses, do not allow corporate fiduciaries to escape liability when there has been a lack of good faith.[109] Delaware, for example, enacted §102(b)(7), which provides that a corporation cannot exculpate "for acts or omissions not in good faith."[110] Courts have further explained that an act is not in good faith and cannot be exculpated if the defendant acted with an "intentional dereliction of duty, [or with] a conscious disregard for one's responsibilities."[111] Due to exculpatory provisions, shareholder litigation almost always includes a breach of good faith. In fact, even where the premise of a lawsuit is failure of oversight—a breach of duty of care claim—the plaintiffs must show that the failure in oversight arose to the level of bad faith to avoid exculpation.[112] Thus, there remains a significant incentive for directors and officers to continue to fulfill their duties.

B. *Enforcement of Fiduciary Duties and Personal Liability*

When a board member or officer breaches their fiduciary duties owed to the company, they may be held *personally* liable for their breach. In more casual terms, if a corporate fiduciary caused monetary damage to the company, they may be financially liable. Derivative suits are one of the main avenues for shareholders to hold officers and directors accountable.[113] This section explains derivative suits and the procedures and difficulties plaintiffs face.

A derivative suit allows a shareholder to bring a lawsuit on behalf of the company against its board and officers as defendants.[114] The lawsuit is a

107. *In re Walt Disney Co. Derivative Litig.,* 906 A.2d 27, at 67 (Del. 2006).

108. *Stone*, 911 A.2d 362, 370 (Del.2006).

109. *See* DEL. CODE ANN. tit. 8, § 102(b)(7)(ii).

110. *Id.*

111. *In re Walt Disney Co.,* 906 A.2d at 64.

112. *In re McDonald's Corp.,* 289 A.3d at 370.

113. *See Aronson v. Lewis*, 473 A.2d at 811, *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ("[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," explaining the importance of the ability for shareholders to bring derivative suits in promoting fairness and justice in corporate law).

114. Angela N. Aneiros, *The Unlikely Pressure for Accountability: The Insurance Industry's Role in Social Change*, 27 TEX. J. C.L. & C.R. 139, 153 (2022). Historically, derivative suits were relatively

"derivative" suit because the shareholder is not bringing the lawsuit to benefit themselves "directly," but is standing in the shoes of the corporation to "enforce a corporate cause of action against officers, directors, and third parties."[115] Any relief granted would be for the benefit of the corporation, not the shareholder personally.

Traditionally, the board members are the ones in charge of deciding whether to bring a lawsuit on behalf of the corporation.[116] When a corporation suffers harm, it is the board's job "to determine what, if any, remedial action the corporation should take . . . ."[117] It is well established that "directors, rather than shareholders, manage the business and affairs of the corporation,"[118] "which encompasses decisions . . . . to initiate, or refrain from entering, litigation . . . ."[119] Consequently, because a derivative suit requires the shareholder to displace the board's authority over litigation, most states have exceptionally demanding prerequisites and high pleading standards.

Among the high pleading requirements, the most essential pre-filing obstacle is the "demand requirement."[120] 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.[121]

A derivative lawsuit, therefore, requires a plaintiff-shareholder to specifically plead (1) that a pre-suit demand was made on the board, which the board wrongfully refused, or (2) explain the reason for not making the required demand.[122]

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uncommon and settlement costs were nominal. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions,* 57 VAND. L. REV. 133, 137 & n.12 (2004) (finding approximately 80% of all fiduciary duty claims filed in the Delaware Chancery Court in 1999 and 2000 were class actions challenging board conduct in an acquisition, while only 14% of fiduciary duty claims were derivative suits). However, in recent years we have seen an increase in derivative suits being filed with more plaintiffs overcoming Rule 12(b)(6) motions and larger settlements. For example, in 2020, Alphabet, Inc. settled a derivative claim for $310 million and Wynn Resorts, Ltd. settled a derivative claim for $41 million. In 2021, L Brands settled derivative suits for a combined total of $90 million. *See generally,* Aneiros, *supra* note 114.

115. *Ross v. Bernhard*, 396 U.S. 531, 534 (1970).

116. *Hughes v. Hu*, No. 2019-0112, 2020 WL 1987029, at *9 (Del. Ch. Apr. 27, 2020); *see* DEL. CODE ANN. tit. 8, § 141(a).

117. *Hughes*, 2020 WL 1987029, at *9.

118. *Aronson v. Lewis*, 473 A.2d at 811.

119. *See* DEL. CODE ANN. tit. 8, § 141(a) (West 2020). Section 141(a) vests statutory authority in the board of directors to determine what action the corporation will take with its litigation assets, just as with other corporate assets. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981).

120. Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 UNIV. CHI. L. REV. 751, 780 (2002).

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

122. *See id.* However, the MBCA does not provide for "demand futility" and rather requires "universal demand." "No shareholder may commence a derivative proceeding until (i) a written demand

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 to 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."[123] Because the business judgment rule applies, once a demand is made on the board and the board refuses the demand, it is very difficult for shareholders to proceed with litigation because the decision is presumed valid unless the plaintiff-shareholder can rebut the presumption.[124]

If no demand was made, the plaintiff may have the option to plead "demand futility."[125] This means that any request made to the board to pursue the claim would have been futile, and as a result, the requirement for making a demand should be excused.[126] The plaintiff would need to plead with particularized facts that there is "reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[127]

Shareholders can find it extremely difficult to plead the particularized facts. Since the plaintiffs have conducted very little, if any, discovery at this point in the litigation, they oftentimes do not have the necessary facts to plead, and therefore cannot rebut the business judgment presumption. For this reason, most derivative suits are dismissed at the pleading stage through a summary judgment motion, also known as a "12(b)(6) motion." To overcome a Rule 12(b)(6) motion, a plaintiff is required to assert factual allegations suggesting that the fiduciary was aware of evidence indicating corporate wrongdoing.[128] Additionally, the plaintiff must present factual assertions indicating that the fiduciary deliberately refrained from taking any action in response.[129] These

has been made upon the corporation to take suitable action and (ii) 90 days have expired from the date delivery of the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period." MODEL BUS. CORP. ACT § 7.42.

123. *Kamen v. Kemper Fin. Servs., Inc.,* 500 U.S. 90, 101, 111 S. Ct. 1711, 1719, 114 L. Ed. 2d 152 (1991); *see also Zapata Corp. v. Maldonado*, 430 A.2d 779, 784, and n. 10 (Del.1981).

124. *See Kamen v. Kemper Fin. Servs.*, *Inc*., 500 U.S. 90, 101 (1991) (citing *Zapata Corp. v. Maldonado*, 430 A.2d at 784 n.10. To rebut the presumption, the plaintiff has the burden of presenting evidence that there is (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision. *See In re Walt Disney Co.,* 906 A.2d 27, 64-66 (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).

125. *See Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou,* No. CV 2019-0816-SG, 2020 WL 5028065, at *15 (Del. Ch. Aug. 24, 2020) (If a demand is not made, plaintiff "must demonstrate that demand on the board to pursue the claim would be futile such that the demand requirement should be excused.").

126. *Id.*

127. *Hughes v. Hu*, 2020 WL 1987029, at *11 (If the majority directors were not "independent and disinterested," the business judgment rule would not apply.)

128. *In re McDonald's Corp.*, 289 A.3d at 376.

129. *Id.*

factual assertions should indicate that the failure to act was "sufficiently sustained, systematic, or striking to constitute action in bad faith."[130] Allegations suggesting that a fiduciary was informed of misconduct but disregarded it or failed to investigate adequately constitute a claim for breach of duty.[131] Consequently, the business judgment rule has generally protected directors and officers from personal liability.

However, there are times when the business judgment rule does not protect directors or officers from personal liability. Significantly, many states[132] prohibit a corporation from indemnifying its directors and officers for any settlement portion of a derivative claim if they are found personally liable to the corporation.[133] For example, Delaware law prohibits indemnification for settlements and judgments "by or in the right of the corporation."[134] This is where D&O insurance steps in—it safeguards directors' and officers' personal assets when found liable to the company.[135]

C. The Role of D&O Insurance

In order to protect the board of directors and officers against legal liability arising out of their role with the corporation, companies purchase D&O liability insurance.[136] D&O insurance protects: (1) the directors and officers from having to pay defense costs, settlements, or judgments from their personal assets in the event they are found personally liable for something; and (2) the assets of the corporation.[137] While each D&O policy is unique, corporations, directors, and officers are typically insured under the three core agreements of D&O insurance: Side A, Side B, and Side C, or "A-B-C" coverage.[138]

130. *Id.*

131. *Id.*

132. All fifty states have passed indemnification statues establishing the conditions and extent under which a corporation may, must, or are prohibited from, indemnifying a director or officer. *See e.g.,* DEL. CODE ANN. tit. 8, § 145 (West 2022); CAL. CORP. CODE § 317 (West 2022); N.Y. BUS. CORP. LAW § 721-725 (McKinney 2016); NEV. REV. STAT. ANN. § 78.751 (West 2019); 805 ILL. COMP. STAT. ANN. 5/8.75 (2012); MD. CORPS. & ASS'NS CODE ANN. § 2-418 (West 2022); N.J. STAT. ANN. § 14A:3-5 (West 2014).

133. *See* Robert A. Johnson, *Delaware Prohibits Indemnification of Costs for Settling a Derivative Suit, but the Rules in Other States May Differ,* 14 ANDREWS CORP. OFFICERS & DIRS. LIAB. LITIG. REP., no. 17, May 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").

134. DEL. CODE. ANN. Tit. 8 § 145 (1953).

135. For a detailed discussion of D&O insurance safeguards for officers' and directors' personal assets *see generally* Aneiros, *supra* note 114, 163-69. *See also* Business Owner's Playbook, *The Who, What & Why of Directors & Officers Insurance*, THE HARTFORD, https://www.thehartford.com/management-liability-insurance/d-o-liability-insurance/explained (last visited June 1, 2023).

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

137. *See id.* at 1797; *see also* Business Owner's Playbook*, The Who, What & Why of Directors & Officers Insurance*, THE HARTFORD, https://www.thehartford.com/management-liability-insurance/d-o-liability-insurance/explained(last visited June 1, 2023) (noting the specifics of D&O coverage).

138. Aneiros, *supra* note 114, at 164.

1. The Policy

Side A is considered the "personal protection" part of the policy. For officers and directors, this is the most important part of the policy as it acts as professional liability insurance for covered individuals, providing reimbursement for damages, settlements, judgments, and defense costs as a result of a legal action.[139] Importantly, it protects the assets of an individual director or officer for claims which the company cannot or will not indemnify the individual.[140]

Historically, Side A coverage would apply when a corporation was insolvent and therefore could not indemnify the board or officers.[141] However, as derivative suits have increased in frequency in recent years and many states prohibit indemnification of derivative suites, Side A coverage is becoming increasingly more important for all corporations, not just insolvent ones.[142]

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.[143] For example, while Delaware law prohibits indemnification for judgments or settlements in actions against a director or officer claiming liability to the corporation, it *permits* indemnification for defense costs if the director or officer "has been successful on the merits or otherwise in defense of any action."[144] The mandatory indemnification provisions create an enforceable right, "*requiring* the corporation to indemnify its directors and officers upon satisfaction of certain statutory prerequisites."[145] Again, turning to Delaware's indemnification statute, it *requires* a corporation to indemnify its directors and officers for any expenses (including attorneys' fees) incurred in defending a lawsuit, to the extent of the director's or officer's success "on the merits or otherwise."[146]

139. *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." Further explaining that D&O can extend to defense costs as a result of criminal and regulatory investigations, but it typically does not cover intentional illegal acts).

140. Julia Kagan, *Directors and Officers Liability Insurance*, INVESTOPEDIA (Jul. 10, 2022), https://www.investopedia.com/terms/d/directors-and-officers-liability-insurance.asp.

141. Baker & Griffith, *supra* note 136, at 1802-03.

142. Aneiros, *supra* note 114114, sections I and II providing how derivative suits have increased in recent years.

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

144. DEL. CODE ANN. tit. 8, §§ 145(b)-(c)(1) (West 2022).

145. McKinney, *supra* note 143, at 738 (emphasis added).

146. DEL. CODE ANN. tit. 8, § 145(c)(1) (providing that "[t]o the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding . . . he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith").

The "entity coverage" part of the policy is under Side C. It ensures that the corporation is covered when the corporation is also named in the lawsuit.[147] For publicly traded companies, who are listed on the stock exchange and therefore fall under federal security laws, Side C covers the company against liabilities due to violations of security laws.[148] Accordingly, in the event shareholders file a lawsuit against such companies for securities-related issues, Side C would indemnify the company for legal costs incurred, including defense costs, settlements, and judgments.

As evidenced by the coverages described above, D&O insurance protects a company's directors and officers in times of crisis and catastrophe.[149] Thus, an expansive and robust D&O insurance policy reduces the board's fears of being personally liable for a liability claim, which incentivizes directors to continue to serve on boards and to take risks to grow their companies.[150]

2. *Premiums and the underwriting process*

Insurance agreements require the policyholder, or insured, to pay a premium and in return the insurer will provide protection against some uncertain potential event. The dollar amount of the premiums is determined during the underwriting process, which requires the underwriter to asses the risk of the insured.[151] However, the business model only works when the sum of the received premiums exceeds the amount paid on insurance claims against the policy. If the amount paid out in claims by insurers exceeds the sum of money received from the policy premiums, insurers face a great risk of loss.[152] Therefore, the underwriting process is extremely important to insurance companies.

In determining the amount of D&O insurance premiums, underwriters are required to quantify the board and officers' influence and risk. A major focus of assessing risk is the evaluating the company's corporate governance.[153] The

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147. Kagan, *supra* note 140; Baker & Griffith, *supra* note 136136, at 1802.

148. *See* Matthew T. McLellan, *Directors and Officers Liability (D&O)*, MARSH, https://www.marsh.com/us/services/financial-professional-liability/directors-and-officers-liability.html (last visited Aug. 10, 2023). For private companies, Side C provides broad entity coverage. *Id.*

149. Kevin LaCroix, *In Lieu of D&O Insurance, Musk Agrees to Provide Tesla with "Coverage"*, THE 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/.

150. *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).

151. *See* Aneiros, *supra* note 114, at 174 ("Underwriting is the process the insurer uses to determine the risks associated with insuring a company in deciding whether to offer coverage, what amounts of coverage, and the price of coverage.").

152. For this reason, many insurance companies carry reinsurance. Reinsurance companies offer insurance to other insurers, safeguarding against circumstances where the underlying insurance company needs to pay more in claims than premiums received. *See* Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 506 and accompanying footnotes (2007).

153. *Id.* at 514-16.

corporate governance analysis involves completing a detailed investigation into the culture of the corporation and character of the named insured, i.e. the individual director or officer. Here, culture includes an examination into the structural features of the company such as compensation, incentives, compliance programs, oversight committees, etc. Character includes an investigation into the "ethics and confidence of the management of the company"[154] wherein they will look into the "reputation, skill set, and litigation history of each individual board member."[155]

There are three primary sources of information underwriters use in making their risk assessments: the application for insurance, independent research, and "underwriter meetings."[156] The application process is similar to any other application for insurance. The insurer requests basic information such as the experience of each officer and director, the claim history of the corporation, and whether there are any current claims that may give rise to litigation. Independent research involves reviewing publicly available information such as SEC filings. In addition, some D&O insurers have their own databases tracking information on every director and officer who has ever been a defendant in a derivative suit.[157] However, since much of the information needed is publicly unavailable, underwriters have a series of meetings with senior officers as well as legal and accounting departments where they ask for private information.[158]

D&O insurance premiums often hold the potential to anticipate corporate governance risk. Having performed a comprehensive examination of a company's governance practices, the resulting premium reflects the associated governance risk for the company.[159] In other words, when a company experiences a rise in its premium, as seen with Tesla, it is often indicative of an elevated corporate governance risk, such as challenges in effectively overseeing and controlling a CEO.

4. D&O Insurance and Corporate Governance

The underwriting process demonstrates how corporate governance is a key consideration when determining whether coverage, policy limits, and premium rates. D&O insurers also have the ability to monitor an insured company's governance practices. For example, they can make insurance coverage contingent on the company improving their governance practices,

154. *Id*. at 523.
155. *Id.* at 525.
156. *Id.* at 510-12.
157. *Id.* at 523.
158. *Id.* at 511-12. Because the information received during underwriter meetings is considered confidential, it is customary for underwriters to enter nondisclosure agreements.
159. *Id.* at 489.

recommending specific actions for the company to take.[160] Failing to have strong governance in place can lead underwriters to raise premiums, limit coverage, and ultimately deny coverage—exposing directors and officers to personal risk. During litigation, D&O insurers may manage the defense and settlement of shareholder claims—determining when coverage is provided or falls under an exclusion.[161] Additionally, D&O insurers may straight out refuse to insure companies with the worst corporate governance practices.

Further, D&O insurance enhances independent boards by playing an incentivizing role in attracting and retaining top talent for outside directors and officers.[162] Since outside directors are not typically part of the executive team, they can provide independent oversight, fostering objective decision-making. For these reasons, D&O insurance plays an important role in promoting good corporate governance by ensuring boards will act in the best interest of the company.

The board of directors plays a crucial role in promoting good corporate governance. While certain protections like the business judgment rule and exculpatory clauses shield directors from liability, shareholders may bring derivative suits against directors for failing to meet their fiduciary duties. A derivative suit puts the director at risk of being held personally liable for the harm done to the company. Since the personal financial exposure is so high, companies take out D&O insurance to protect their directors and officers. The insurance premiums companies paid by the companies are reflective of their corporate governance health. Therefore, when a company is quoted "disproportionately high premiums" by D&O insurers, it is evidence of corporate governance gone wrong.

IV. AN ILLUSTRATION: MUSK'S THREAT TO CORPORATE GOVERNANCE

The inability of Tesla's board to effectively monitor and control Musk's social media conduct was a high-profile illustration of how superstar CEOs can jeopardize corporate governance. While the board's deficient monitoring is evident from Musk's tweets, there are larger concerns regarding oversight. To amplify oversight challenges, Musk essentially eliminated board independence by personally insuring the board of directors.

In Section A, the implications of Musk's arrangement to personally insure the board members both on the company and the independence of the directors

160. *Id.* at 488-89.

161. D&O insurance policies have common exclusions, such as fraud, false and misleading statements, deliberately wrongful misconduct, dishonest acts, intentional non-compliant acts, or intentional violations of statutes. Thus, they can withhold insurance benefits from directors or officers who have engaged in one of these exclusions.

162. *See* Otto & Weterings, *supra* note 150, 108 (citing Baker & Griffith, *supra* note 136, 502); *see also* Noel O'Sullivan, *Insuring the Agents: The Role of Directors' & Officers' Insurance in Corporate Governance,* 64 J. RISK & INS. 545, 549 (1997).

are clarified. Section B provides an in-depth exploration of the potential breach of fiduciary duties that could arise under such an agreement and outlines the consequences of the agreement for Musk to personally insure the directors on board independence. It concludes by highlighting how Musk personally insuring the Tesla board compromises the important role of D&O insurance in upholding oversight responsibilities and undermining the merits of practicing good corporate governance.

A. Board Independence?

When Tesla decided to not renew its D&O insurance policy in April 2020, it was replaced with a promise by Musk to personally provide the board members with "substantially equivalent" coverage to what insurers would provide.[163] According to Tesla's 2019-K/A Annual Report for the year 2019, instead of renewing its D&O insurance, "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."[164] However, it did not describe what is "substantially equivalent." Significantly, it appears that the Tesla-Musk agreement was limited to the equivalent of Side A-only 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."[165] In other words, Musk would reimburse the directors' and officers' expenses up to $100 million, but only if Tesla was prohibited from indemnifying the fiduciary.

As previously explained, Tesla would not be able to indemnify the directors in a situation where directors or officers are found liable to the corporation, as outlined above.[166] However, if Tesla was statutorily required to indemnify or permitted to indemnify director liability, Musk would not be obligated to indemnify, and Tesla would be required to reimburse the costs. Consequently, the expenses associated with any indemnification required or permitted by a company would be reimbursed directly by Tesla with no assistance of insurance, including Musk as the insurer.

This agreement was extremely controversial. Under the agreement, each director relied on Musk to cover any company or board members' costs for legal defenses, settlements, or judgments against them. The Tesla board clearly

163. *V. Stockholder Derivative Compl., Gharrity v. Musk*, No. 2021-0199, ¶ 90 (Del. Ch. Mar. 11, 2021).

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

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

166. *See supra* III (A)(1)(b) and (C)(1) (many states' indemnification statutes prohibit companies from indemnifying directors and officers for any settlement portion of a derivative claim).

anticipated public concern over the Tesla-Musk agreement and attempted to eradicate it 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**.[167]

In this statement, the board attempts to preempt criticism of their independence by clarifying that the Tesla-Musk agreement would not influence their business judgment.

Nevertheless, many questioned the veracity of the board's disclosure. Shareholders argued in the March 2021 complaint that the agreement made it "impossible for the board to be independent."[168] As explained in the complaint:

> the Board is insured, and thus indemnified, by Musk *personally* for a majority of the harm caused by Musk alleged herein. The Board cannot be considered independent in any way from Musk in these circumstances. Musk could refuse to pay out the "insurance policy" if the Board elected to proceed with an investigation of him, and the Board would have every incentive to abandon that investigation.[169]

The complaint further explained:

> Musk 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.[170]

Furthermore, in June 2020, the two largest proxy advisor firms,[171] Glass Lewis and Institutional Shareholder Services Inc. ("ISS"), urged Tesla investors to vote against reelecting chairwoman Robyn Denholm.[172] Glass Lewis' recommendation to vote against Denholm, an "independent" director, was based on corporate governance concerns directly related to the Tesla-Musk insurance agreement.[173] According to Glass Lewis: "We are concerned that this D&O arrangement gives the company's independent directors a direct, personal

167. Tesla, Inc., Annual Report, *supra* note 164 (emphasis added).

168. *See Chase Gharrity*, No. 2021-0199 at ¶ 254 (Del. Ch. Mar. 11, 2021).

169. *Id.*

170. *Id.* at ¶ 90.

171. Proxy advisory firms provide investors with recommendations on management and shareholder proxy proposals that are voted on at corporate annual and special meetings. Proxy advisory firms have significant influence over the voting decisions of institutional investors and the governance choices of publicly traded companies. *See* Cassidy Alexander, *The Role of Proxy Advisory Firms,* Glass Lewis (Jan. 14, 2022), https://www.glasslewis.com/the-role-of-proxy-advisory-firms/*;see also* James Copland et al., *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* Stanford University Closer Look Series (May 30, 2018) https://www.gsb.stanford.edu/faculty-research/publications/big-thumb-scale-overview-proxy-advisory-industry) (providing a comprehensive review of the proxy advisory industry and the influence the firms have on voting behavior).

172. Bhargav Acharya & Kanishka Singh, *Glass Lewis Joins in Opposing Chairwoman's Re-Election to Board,* REUTERS, (Jun. 17, 2020, 2:50 AM), https://www.reuters.com/article/tesla-glass-lewis-idINKBN23P0FT (Robyn Denholm has been an independent director since 2014. She succeeded Musk as the chair in 2018 when he was required to step down).

173. *Id.*

financial dependency upon the CEO they are tasked with overseeing."[174] Since Denholm headed the committee responsible for approving the insurance arrangement, Glass Lewis recommended voting against her re-election.[175] The insurance agreement between Musk as CEO and the board made their relationship too close for comfort.

Agreements by which a director or officer personally insures the other corporate fiduciaries of the company, such as the Musk-Tesla agreement, create a dependency between those insured and the insurer's personal wealth. Here, the Musk-Tesla agreement created a dependency on the board with Musk's personal financial ability to follow through with his commitment.[176] Moreover, the fact that the board relies on Musk and his wealth also raises concerns about the board's own interest in maintaining Musk's wealth. Musk's wealth directly impacts the board: they must ensure it remains intact for him to follow through with his commitment to indemnify the board. Although it may appear an unlikely concern—that the world's richest (or second richest) man[177] would be unable to honor his financial commitments—things can change.[178] Much of Musk's wealth is intricately tangled with Tesla's performance, as the majority of his wealth is tied up in Tesla.[179] In November of 2021, Musk's net worth was $340 billion, but by January 2023 it was down to $137 billion.[180] The loss of over $200 billion was largely due to the poor performance of Tesla stocks in recent years, which saw a 65 percent plunge in 2022.[181] It is plausible that the directors could have found themselves in a situation where they required Musk's assured "coverage" precisely when both Musk and Tesla have experienced a significant downturn in wealth.[182]

174. *Id*.

175. *Id.*

176. *See* LaCroix, *supra* note 149.

177. Sheila Chiang, *Elon Musk is the World's Richest Person Again,* CNBC (Jun. 1, 2023, 1:12 AM EDT), https://www.cnbc.com/2023/06/01/elon-musk-is-the-worlds-richest-person-again.html.

178. *See* LaCroix, *supra* note 149 (discussing an arrangement similar to Musk personally insuring the board. It involved a privately held commercial bank. Rather than carry tradition D&O insurance, the bank's founder, Chairman, and largest shareholder had provided personal indemnification undertakings to the members of the bank's board of directors. The Chairman was one of the wealthiest individuals in the bank's town and indeed in the bank's state. However, the bank Chairman's wealth was tied up entirely in his ownership of the bank. Ultimately, the bank failed. Since the directors had no D&O insurance and the Chairman's personal indemnity was worthless, the directors were forced to face the ensuing FDIC receivership with only their own personal assets for protection).

179. David Goldman, *Elon Musk Has Lost a Bigger Fortune Than Anyone in History,* CNN BUSINESS (Jan. 3, 2023, 5:28 AM ET), https://www.cnn.com/2023/01/02/investing/elon-musk-wealth/index.html.

180. *Id.*

181. *Id.*

182. LaCroix, *supra* note 149.

B. The Board's Potential Breach of Fiduciary Duties

Boards must maintain independence to uphold the primary principles of corporate governance and ensure the best interests of the company. The lack of board independence in the Tesla-Musk insurance agreement demonstrates the potential for failure to maintain fiduciary duties. It eradicates any meaningful oversight over his conduct and decisions and shifts loyalty from the company to Musk, jeopardizing the best interest of the company.

1. Lack of Oversight

If there was any doubt that the Tesla board believed Musk to be essential to the company's value, the Delaware Chancery Court cleared it when they held that the Tesla board is "well aware of Musk's singularly important role in sustaining Tesla" and "providing the vision for the Company's success."[183] When a CEO is thought of as being "essential to company value," directors' ability to effectively monitor the CEO is often diminished.[184]

Tesla's board has continuously been fined and sued for their failure to oversee Musk, causing harm to the company. Shareholders consistently allege that the board continually fails to "exercise effective oversight of Musk."[185] Each time a director is sued for failing to monitor, the director faces personal liability and D&O insurance would protect their personal assets. When the CEO replaces the D&O insurer and becomes responsible for indemnifying the board, the board develops dependency on the CEO. This type of relationship "would make it more difficult for board members to exercise good oversight on behalf of all shareholders."[186]

Consider, for example, Musk is accused of illegal price fixing on behalf of Tesla. If true, his actions would violate antitrust laws and expose Musk and Tesla to criminal liability. The board's duty to oversee management includes Musk as CEO. If they investigate and the claims are true, it may be serious enough that the board must terminate Musk's employment as CEO. If they do not investigate, they will not need to make such a decision, but they may face liability for failing

183. *In re Tesla Motors, Inc. S'holder Litig.,* No. 12711-VCS, 2018 WL 1560293, at ¶ 16 (Del. Ch. 2018).

184. Hamdani & Castiel, *supra* note 7, at 1378-79 (2023) (stating: "The notion that successful CEOs gain leverage over boards was noted by Hermalin and Weisbach. They use this insight to explain why CEOs might have a say on director appointment)*;see also* Benjamin E. Hermalin & Michael S. Weisbach, Endogenously Chosen Boards of Directors and Their Monitoring of the CEO, 88 AM. ECON. REV. 96, 97 (1998) ("If a CEO keeps his job, then retaining him must be worth more to the directors than replacing him. This means that this CEO is, to some extent, a rare commodity, which gives him bargaining power vis-à-vis the directors").

185. *In re Tesla Motors, Inc. S'holder Litig.,* No. 12711-VCS, 2018 WL 1560293, at ¶ 1.

186. Lora Kolodny, *Tesla paid CEO Elon Musk $3 Million to Provide Indemnity for Directors and Officers Against Legal Claims*, CNBC (Oct. 27, 2020, 3:42 PM EDT), https://www.cnbc.com/2020/10/26/tesla-paid-elon-musk-millions-for-90-days-indemnification-insurance.html.

their duty of oversight by way of a derivative action brought by shareholders. Moreover, if the board fails to investigate and are later held personally liable for that failure, they would be dependent on Musk to provide indemnification.

The board has authority over Musk, but he has control of their ability to be indemnified. Would this not play a part in the decision whether to investigate or terminate Musk? The board is aware of the "red flag" and faces a decision to investigate or not. Then, the decision to terminate Musk or not needs to be made in good faith and in the best interest of the company. The court has already held that the Tesla board is "well aware of Musk's singularly important role in sustaining Tesla" and "providing the vision for the Company's success."[187] The board is therefore unlikely to want to fire Musk.

It is possible for a shareholder to make a demand on the board to terminate Musk and the board refuses. The shareholder may then bring a derivative action against Musk and the other directors claiming they wrongfully refused the demand and failed their oversight duties. Because the board's refusal of the demand would be "subject only to the deferential 'business judgment rule' standard of review" and presumed valid, the shareholder plaintiff would need to rebut the presumption.[188] 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 because they are reliant on Musk to protect their personal assets if found personally liable.[189]

Alternatively, rather than making a demand on the board, a shareholder could bring a derivative claim against Musk and the other directors alleging demand futility. In pleading demand futility, the shareholder plaintiff would allege with particularity that there was a reasonable doubt the board was capable of making an independent decision.[190]

Under either scenario, the plaintiff would argue that there are no disinterested board members, each is dependent on Musk for indemnification. During the entire litigation period, the board would be dependent on Musk for indemnification if the suit was not dismissed. If the directors were found personally liable, in theory Musk would reimburse them for their defense costs and any legal judgments. If the suit were dismissed, Tesla would pay the entire cost of litigation without any assistance of insurance because they did not renew the insurance.

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187. *In re Tesla Motors, Inc. S'holder Litig.,* No. 12711-VCS, 2018 WL 1560293, at 16.

188. *Kamen v. Kemper Fin. Servs.*, 500 U.S. at 101.

189. However, "sufficiently independent" is somewhat vague. As noted in Velasco'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* Velasco, *supra* note *93* at 1037-38.

190. *See United Food & Com. Workers Union v. Zuckerberg,* 250 A.3d 862, 890 (Del. Ch. 2020), *aff'd sub nom. United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, No. 404, 2020, 2021 WL 4344361 (Del. Sept. 23, 2021) (clarifying the demand futility requirement that plaintiffs must meet in order to bring a derivative action).

2. *Loyalty to Whom?*

The duty of loyalty requires loyalty to the corporation above all else, including oneself. With a superstar CEO, where is the loyalty of the board? The power of superstar CEO may very well "undermine board effectiveness in preventing opportunistic self-dealing by superstar CEOs."[191] The board "may permit superstar CEOs to engage in harmful self-dealing" to the "extent that the cost to the company from such transactions does not exceed the value of the CEO's singular contribution to the company."[192]

As previously explained, when a corporate fiduciary is on both sides of a transaction, they are involved in an interested transaction. Here, the transaction is Tesla and Musk entering an agreement for Musk to personally insure the board. Regarding the Tesla-Musk agreement, Musk 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 Musk's personal indemnification, Tesla disclosed that they "agreed to pay our 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%."[193]

Recall, when faced with an interested transaction such as the Tesla-Musk insurance agreement, the court must first look at whether the interested party was a controlling shareholder. Here, the interested party is Musk. Because Musk only owns far less than 50 perfect of Tesla stock, Tesla would argue he is not a controlling shareholder and therefore, the decision to enter the insurance agreement should fall under the business judgment rule.

But if Musk was treated as a controlling shareholder, Tesla directors could not rely on the business judgment rule to protect them. As the Delaware court has already treated Musk as a controlling shareholder of Tesla, it is possible they would do so again.[194] As an interested party and controlling shareholder, the decision to enter the Tesla-Musk agreement would be scrutinized under the intrinsic fairness test. Musk would bear the burden of proving the Tesla-Musk agreement was fair both procedurally and substantively.[195] Had the claim

191. Hamdani & Castiel, *supra* note 7, at 1399.

192. *Id.* at 1400.

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

194. The court found it "reasonably conceivable" that Musk was a controlling shareholder because "(1) Musk's ability to influence the stockholder vote to effect significant change at Tesla, including the removal of Board members; (2) Musk's influence over the Board as Tesla's visionary, CEO and Chairman of the Board; (3) Musk's strong connections with members of the Tesla Board and the fact that a majority of the Tesla Board was "interested," as that term is defined in our law, in the Acquisition; and (4) Tesla's and Musk's acknowledgement of Musk's control in its public filings." *In re Tesla Motors, Inc. S'holder Litig*., 2018 WL 1560293, at *13.

195. 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

continued through litigation, it is possible the judge would rule that the agreement was intrinsically fair. We have seen it before in the Tesla-SolarCity lawsuit. There, the court found that Musk initiated and benefited from an interested transaction.[196] However, despite admitting the process of the interested transaction was "far from perfect," the court ruled it was entirely fair and a protected valid transaction.[197]

The final avenue to help Tesla and Musk with this transaction would be under the safe harbor doctrine. Turning to the first way to ratify—the good faith authorization by most of the disinterested directors. This route would "cleanse." There is no doubt the board was fully informed about the nature of the transaction. However, in creating the Tesla-Musk agreement, *none* of the board members were disinterested. Each one of the directors was personally affected by the transaction; each relied on Musk to cover any costs they incurred, including judgments and settlements, if Tesla was unable to indemnify. Therefore, it could not be affirmed by a majority of the disinterested board of directors. If it was approved by a conflicted board, and Musk is treated not as a controlling stockholder, "a fully informed vote by the majority of Tesla's disinterested minority stockholder [would] "cleanse" any breach of fiduciary duty by triggering the business judgment rule."[198] This is the second way for the transaction to be ratified. However, this was impossible after the fact. The Tesla-Musk agreement was never put before the shareholders to vote. This was a decision made only by the board of directors. Had the shareholders voted on it, the decision to go forward with the Tesla-Musk insurance agreement would likely have been protected from litigation under safe harbor statute if Musk were not treated as a controlling shareholder. However, if Musk were treated as a controlling shareholder, the transaction would be subject to the entire fairness test.[199]

The Tesla-Musk insurance agreement undermines the fundamentals of corporate governance, stripping away any board independence that may have existed. The board has become dependent on Musk's personal wealth for

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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).

196. *See generally, In re Tesla Motors, Inc. S'holder Litig*., No. 12711-VCS, 2022 WL 1237185 (Del. Ch. Apr. 27, 2022).

197. *Id.* at *2, *judgment entered sub nom. In re Tesla Motors, Inc.* No. 12711-VCS, 2022 WL 1267229 (Del. Ch. Apr. 27 2022), *aff'd sub nom. In re Tesla Motors, Inc. S'holder Litig.*, 298 A.3d 667 (Del. 2023). One reason the transaction was "far from perfect" is that despite Musk being on both sides of the transactions, he was involved in the deliberations, assisting the decision to go forward with a deal he would benefit from. However, the court found directors' testimony persuasive: they thought it would be better for Tesla to have the benefit of Musk's vision and *expertise* in evaluating the acquitision, rather than excluding him entirely. *In re Tesla Motors, Inc. S'holder Litig*., No. 12711-VCS, 2022 WL 1237185, at *15, n. 197. *See also* Tyler O'Connell, *Supreme Court Affirms Decision That the SolarCity Acquisition was Entirely Fair,* JDSUPRA (Jun. 21, 2023), https://www.jdsupra.com/legalnews/supreme-court-affirms-decision-that-the-2193838/.

198. *In re Tesla Motors Stockholder Litig.*, C. A. 12711-VCS, at 77 (Del. Ch. Apr. 27, 2022).

199. *See supra* §III (A)(2) for a detailed explanation of safe harbor statues and the entire fairness test.

indemnification. Moreover, the arrangement erodes the board's ability to faithfully discharge its fiduciary duties, influencing whether the board meets its oversight duties and inherently creates a conflict of interest in which the board's loyalty from the best interest of the company to the best interest of Musk. Such arrangements to allow corporate fiduciaries to insure their fellow directors or officers, must therefore be prohibited to ensure good corporate governance and accountability for breaches of duty.

V. LIMITING POWER IN THE ABSENCE OF ACCOUNTABILITY

To promote corporate governance and safeguard fiduciary duties, there must be measures in place to hold corporate officers, especially superstar CEOs, accountable for their behavior. This section contends that, more often than not, superstar CEOs evade significant accountability; it concludes by proposing state action to promote proper corporate governance. Section A circles back to the "funding secured" derivative litigation, detailing how Musk was ultimately not found personally liable. Section B emphasizes the necessity of holding superstar CEOs accountable. Section C reviews and discusses the shortcomings of accountability mechanisms suggested by other scholars. Finally, Section D provides a selection of laws authorizing corporations to purchase and provide insurance, ultimately recommending that these laws are amended to prohibit corporate fiduciaries from personally insuring the companies they serve.

A. Lack of Accountability: Musk "Not Liable"

Judge Edward M. Chen, presiding over the "funding secured" derivative litigation against Musk and Tesla, concluded as a matter of law that the tweets at issue were made with *scienter*: they were false and made recklessly without regard to the truth.[200] The case continued in front of a jury to determine whether the tweets were material and whether investors relied upon them.[201] During the trial, Musk explained that "just because I tweet something does not mean people believe it or will act accordingly."[202]

After a three-week trial, the jury deliberated in less than two hours.[203] Ultimately, the jury found the quintessential superstar CEO not liable for

200. Hyunjoo Jin, *U.S. Judge Says Musk Recklessly Tweeted that 'Funding Secured' for Taking Tesla Private,* REUTERS (May 11, 2022, 9:35 AM PDT), https://www.reuters.com/business/autos-transportation/court-says-musk-recklessly-tweeted-that-funding-secured-taking-tesla-private-2022-05-11/.

201. *Id.*

202. Jody Godoy, *Musk to Jury: Just Because I Tweet Something, Doesn't Mean People Believe It,* REUTERS (Jan 20, 2023, 8:25 PM PST), https://www.reuters.com/legal/musk-expected-take-stand-trial-resumes-over-tesla-tweet-2023-01-20/.

203. Michael Liedtke, *Jury: Musk Didn't Defraud Investors With 2018 Tesla Tweets,* THE ASSOCIATE PRESS (Feb. 3, 2023, 5:39 PM PDT), https://apnews.com/article/elon-musk-twitter-inc-technology-san-francisco-business-2a404f251ca348c876fed81e9d5c676d.

investors losses following his misleading tweet that funding was secured.[204] According to the jury, the tweets were not material and investors did not rely on the tweets in making investment decisions.[205] One of the jurors was quoted in the New York Times, saying, "[t]here was nothing there to give me an 'aha' moment . . . [Musk] is a guy who could sneeze and the stock market could react."[206]

Corporate scholars were shocked by the verdict. Adam C. Pritchard, a law professor at the University of Michigan, stated that Musk was "crazy to try his chances at trial, given the stakes involved." If Musk lost the suit, he would have had to pay out billions of dollars to investors. Pritchard was also floored by the verdict, given Judge Chen's pretrial ruling on the August 7th tweets. Pritchard observed: "You're fighting with one hand behind your back in that situation—and yet he won."[207] Professor Karen Woody at Washington and Lee University School of Law said that she thought the SEC had a "rock solid" case.[208] Elaborated that the verdict will further empower Musk, Professor Woody explained that "[h]e pushed the boundaries, and won . . . I expect Elon is going to write anything he wants . . . ."[209] Recognizing that Musk has tweeted more than 22,000 times to his more than 128 million followers, analysts agree that he has no reason to slow down his posting.[210]

The Wall Street Journal also noted that this case "is another example of [Musk's] unusual appetite for seeing cases through to trial."[211] The case, and its outcome is unique considering that for over twenty years, "less than 0.2% of federal securities class-action cases . . . were tried to a verdict."[212] Former SEC Commissioner and Stanford Law School professor Joseph Grundfest commented that of the cases that do proceed to trial, both plaintiffs and defendants prevailed around half the time.[213] Grundfest explained that it "[becomes] a coin toss," so why not avoid the lengthy and expensive trial and "split the baby?"[214]

Ultimately, the D&O Tesla-Musk insurance arrangement was not litigated. Prior to the verdict in the "funding secured" derivative suit, Tesla announced that it would not extend the term of the agreement with Musk, choosing to instead

204. *Id.*

205. Rebecca Elliott & Meghan Bobrowsky, *Elon Musk Found Not Liable in Trial Over Tweets Proposing to Take Tesla Private,* THE WALL ST. JOURNAL (Feb. 3, 2023, 8:06 PM ET), https://www.wsj.com/articles/elon-musk-found-not-liable-in-trial-over-tweets-proposing-to-take-tesla-private-11675464951.

206. Huang & Eavis, *supra* note 27.

207. *Id.*

208. Jody Godoy & Jonathan Stempel, *Elon Musk Likely to 'Double Down' on Tweets After Court Victory,* REUTERS, (Feb. 3, 2023, 5:07 PM PST), https://www.reuters.com/technology/billionaire-musk-likely-double-down-tweets-after-court-victory-2023-02-04/.

209. *Id.*

210. *Id.*

211. Elliott & Bobrowsky, *supra* note 205.

212. *Id.*

213. *Id.*

214. *Id.*

bind "a customary directors' and officers' liability insurance policy with third-party carriers."[215] Nevertheless, as detailed in Section III, the implications arising from the mere ability to enter into such an agreement give rise to corporate governance concerns. Further, even if the Tesla-Musk agreement was still in place at the time of the trial, Musk would not have been required to indemnify any directors or cover his own litigation costs because he was "successful on the merits or otherwise in defense of any action."[216] Rather, Tesla would have indemnified the cost of litigation rather than Musk with no insurance to repay the company. Consequently, shareholders' attempt to hold Musk accountable for the harm he inflicted on Tesla resulted in further harm to Tesla by requiring it to pay the litigation costs of the "funding secured" derivative litigation.

B. The Need for Accountability

The Musk case demonstrated how superstar CEOs may behave beyond the permitters the law imposes. "Musk lives by his own rules, or so it seems."[217] Superstar CEOs may engage in misconduct and other inappropriate behavior, leading to negative consequences for the company. And yet, they are too often not held accountable for their bad behavior. Clearly, boards have limited power to effectively control superstar CEOs, preventing their ability to exercise their oversight duties as required. Without monitoring duties, "boards might opt to remain ignorant of misconduct because they would rather not confront a superstar CEO,"[218] or perceive the value to the company as greater than the possible damage done to the company if the CEO is reprimanded, especially if the misconduct would lead to their removal. The result is that we see questionable decisions that may be in the best interest of the CEO but not the company. Further, when superstar CEOs do not face repercussions, it signals to others that they too can behave that way.[219] The law therefore needs to find ways to limit superstar CEO power and strengthen board's ability to faithfully fulfill their fiduciary duties, providing effective oversight.

215. Tesla, Inc., Quarterly Report (Form 10-Q) 30, 32 (Oct. 26, 2020). Following the announcement that Tesla has secured third-party D&O insurance, Glass Lewis withdrew its objections to Denholm's reelection, stating that Tesla's improved liability insurance policy for directors prompted it to reverse its recommendation; *see generally* Kanishka Singh, *Glass Lewis recommends Tesla chairwoman's re-election After opposing it earlier,* REUTERS (Sept. 2, 2020, 1:42 AM PDT), https://www.reuters.com/article/tesla-glass-lewis/glass-lewis-recommends-tesla-chairwomans-re-election-after-opposing-it-earlier-idUSKBN25T17X.

216. DEL. CODE ANN. tit. 8, § 145 (c) (West 2022). *See* discussion *supra* Section III for a detailed explanation of when companies are prohibited, permitted, and required to indemnify directors and officers.

217. Godoy & Stempel, *supra* note 208 (quoting Kim Forrest, chief investment officer at Bokeh Capital Partners).

218. Hamdani & Castiel, *supra* note 7, at 1408.

219. *You shouldn't be a jerk to get ahead,* HARVARD L. TODAY (Feb. 7, 2023) https://hls.harvard.edu/today/the-business-ethics-of-elon-musk-tesla-twitter-and-the-tech-industry/.

C. Accountability Mechanisms

Recently, academics suggested possible ways to limit the power of superstar CEOs. For example, as a reflection of recent court decisions, the law could treat superstar CEOs as controlling shareholders even when they do not hold the majority of shares:

> Treating powerful CEOs as controlling shareholders can be justified under the view that corporate law should prevent superstar CEOs from using related-party transactions to capture some of their unique contribution to company value. Powerful investors presumably can protect a company from CEOs whose actions, through mismanagement or self-dealing, reduce its value. But shareholders' power—especially their power to vote directors out of office—is likely less effective in preventing CEOs with unique contribution to company value from diverting some of that extra value to their own pockets.[220]

This may impose a check on interested transactions because, as previously explained, if the transaction concerns a controlling shareholder the standard of review for the transaction is the intrinsic fairness doctrine rather than the business judgment rule. Thus, treating superstar CEOs as controlling shareholders would encourage the board to disclose interested transactions to shareholders for a vote to limit liability under safe harbor laws.

Take the Tesla-Musk D&O insurance agreement, for example. It was a self-dealing transaction where Musk was on both sides of the transaction; rather than paying an independent insurance company, Tesla paid Musk 3 million dollars for his promise to personally insure the company for 90 days.[221] As explained, this was not put to a vote before the shareholders, but decided by the board. If Musk was not a controlling shareholder, the agreement would fall under the business judgment rule but as a controlling shareholder, the transaction would be reviewed under the intrinsic fairness test. As a transaction involving a controlling shareholder, had Musk and the Tesla board disclosed the agreement and put it to a shareholder vote, they could have reduced their chance of liability.

While this seems like an effective accountability mechanism, legally, it's difficult, or even impossible, to define someone as a superstar CEO. A court would first need to determine that the CEO was a superstar before they would be considered a controlling shareholder. This determination would only be effective *after* a deal had been complete and, even then, only *if* a shareholder wanted to bring a lawsuit to show that the transaction does not meet the intrinsic fairness test. This would be exceedingly unlikely when the transaction does not immediately affect the bottom line for the company or shareholders—including situations like Musk's D&O insurance agreement.

Another method of accountability is requiring boards to be more independent. As previously mentioned, independent directors are viewed as

220. Hamdani & Castiel, *supra* note 7, at 1400.

221. Tesla, Inc., Quarterly Report (Form 10-Q) 32 (Oct. 26, 2020).

strengthening the duty of oversight because they are outsiders, removed from the operations of the company. They have no business ties to any officers, including the CEO, and thus, in theory, have no self-interest in business decisions. The actions of outside directors are, theoretically solely for the best interest of the company. Unfortunately, CEOs are often a part of the nominating committees for independent directors.[222] As Lorsch and Young have explained, "[i]t is no exaggeration to say that many directors are beholden to the CEO for their position, when they are in fact supposed to be monitoring the CEO's performance/position."[223] Further, as Kastiel and Nili have pointed out, independent directors rely heavily on company insiders (in particular the CEO) as sources of information for their decisions.[224] Having no part of the day-to-day operations of a corporation creates a dependency on others for information regarding the overall health and performance of the business. Understandably, this creates potential issues in the effectiveness of their oversight duties: the people they are tasked with monitoring are the people providing the information.

D. Regulating D&O Insurance

A more effective accountability method is through regulations, which establishing rules, standards, and procedures to be followed and accountability through compliance requirements. Regulation is a key tool that federal, state, and local governments use to execute their policy goals—including those related to corporate governance. The Regulatory Transparency Project noted in a 2017 study that while the *goals* of regulations are often shared by lawmakers on both sides of the aisle, oftentimes lawmakers disagree on how to *structure* that regulation to advance the goal.[225]

State statutes contribute to the manageability of a corporate fiduciary's personal liability risk, by affording directors and officers to avoid personal liability through exculpation clauses,[226] safe harbors,[227] indemnification, and insurance. At one time, there were concerns about allowing corporations to provide officers and directors with liability insurance. The belief was that having insurance would create a "moral hazard" causing insureds to be less careful in

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222. *See, e.g.,* Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1833 (1999).

223. *See* Jay Lorsch & Jack Young, *Pawns or Potentates: The Reality of America's Corporate Boards*, 4 EXECUTIVE 85, 86 (1990).

224. Kastiel & Nili, *supra* note 78, at 27.

225. Howard Beales et al., *Government Regulation: The Good, The Bad, & The Ugly,* Regulatory Transparency Project of the Federalist Society (Jun. 12, 2017), https://rtp.fedsoc.org/paper/government-regulation-the-good-the-bad-the-ugly/.

226. *See* discussion *supra* Section III.A.1

227. *See* discussion *supra* Section III.A.2

discharging their duties.[228] However, as liability increased, directors and officers became "increasingly concerned with the potential liability arising from their status with the corporation."[229] For many, despite the benefits, the potential personal liability that came with serving as a director was too high and they decided not to serve.[230] Consequently, corporations petitioned legislatures to enact explicit statutes authorizing indemnification.[231] In response, states responded by enacting statutes intended to limit the personal liability exposure of directors. Today, many states explicitly allow for insurance through their corporate laws. For example, DEL. CODE. ANN. tit. 8, §145(g) states in pertinent parts:

> A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . . against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.[232]

D&O insurance is now recognized as having an incentivizing role in attracting and retaining top talent for outside directors and officers, therefore enhancing independent boards.[233] It is not enough to provide competitive compensation; it is "also necessary to provide for a shield against the threat of lawsuits, the promise of indemnification and directors and officers liability insurance."[234]

Although companies have the power to obtain insurance for directors and officers, most statutes lack any specific guidance on the methods or criteria for obtaining such insurance. While the majority of corporations obtain insurance through third-party D&O insurers, rising premiums have companies looking for alternatives.[235] Recently, the Delaware Code was amended to provide clarity and explicitly allow for captive insurance policies. Captive insurance is directly or indirectly owned, controlled, and funded by the corporation. Under DEL. CODE ANN. tit. 8, §145: "insurance shall include any insurance provided directly or

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228. *See e.g.*, KENNETH S. ABRAHAM, THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11, Chapter 1 (2008) (Providing an overview and history of moral hazard in the insurance industry).

229. Kurt A. Mayr II, *Indemnification of Directors and Officers: The Double Whammy of Mandatory Indemnification under Delaware Law in Waltuch v. Conticommodity Services, Inc.* 42 VILL. L. REV. 223, 223 (1997).

230. *Id.* at 231.

231. *Id.* at 232-33.

232. Del. CODE ANN. tit. 8, §145(g) (West 2022).

233. *See* Rene 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) (*citing* Baker & Griffith, *supra* note 136, 502); *see also* O'Sullivan, *supra* note 162, 549 (missing parenthetical).

234. Denis J. Block et al., *Indemnification and Insurance of Corporate Officials,* 13 SEC. REG. L.J. 239, at 239 (1985).

235. Daniel Krane et al., *D&O Coverage Alternatives: Self-Funded Side A Directors and Officers Coverage,* JDSUPRA (Nov. 22, 2021), https://www.jdsupra.com/legalnews/d-o-coverage-alternatives-self-funded-9186486/.

indirectly. . . by or through a captive insurance company organized and licensed in company with the laws of any jurisdiction . . . ."[236] In order to avoid conflicts of interests, Sec. 145(g)(2) provides "any determination to make a payment under a captive insurance policy in respect of a claim against a current director or officer must be made either by a third-party administrator or in accordance with the procedures set forth in paragraphs (d)(1) through (4) of Sec. 145."[237] The legislative comments explain that the restrictions set in Section 145(g)(2) are "to ensure that the **persons claiming entitlement to payment** under the captive insurance policy **are not the same persons making the decision whether to pay claims** under the policy."[238]

Under both third-party insurers and captive insurance policies, decisions relating to the response of the coverage are independent of the company and/or the individual indemnifying parties (like controlling shareholders). In this manner, both third-party insurers and captive insurance policies circumvent potential worries regarding influence from the company's management, board members, and/or indemnifying parties, as well as potential public policy issues that could emerge for specific types of claims.[239]

An individual personally insuring the company's corporate fiduciaries is vastly different than a corporation insuring through a third-party insurer or captive insurance policy. Third-party and captive insurance policies safeguard director and officer independence and avoid conflicts of interest. Ensuring that companies utilize either of these policy types avoid Musk's situation, where he created an inherent conflict of interest by personally insuring the board. 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."[240]

As demonstrated by the Musk case, allowing corporate fiduciaries to personally insure their own companies undermines many of the advantages of having D&O insurance and reinstates the moral hazard problem—effectively hindering directors from carrying out their fiduciary duties. Having an officer control whether a director will be indemnified for their actions or inaction creates a situation where a director may be faced with the decision to either faithfully carry out their oversight duties over that same officer or consciously disregard

236. DEL. CODE ANN. tit. 8, §145(g) (West 2022).

237. DEL. CODE ANN. tit. 8, §145(g)(2) (West 2022). DEL. CODE ANN. tit. 8, §145(d)(1) through (4) provides that the determination of whether an officer or director should be indemnified must be made in one of the following ways: "(1) By a majority vote of the directors who are not parties to such action, suit or proceeding, even though less than a quorum; or (2) By a committee of such directors designated by majority vote of such directors, even though less than a quorum; or (3) If there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion; or (4) By the stockholders."

238. S.B. 203, Gen. Assemb., 151st Sess. (Del. 2021-2022) (emphasis added).

239. Krane et al., *supra* note 235.

240. Kolodny, *supra* note 186.

their oversight duties. Directors may be in a position where they cannot fulfill their fiduciary duties without the possibility of retaliation from the insurer—in Tesla's case, without possible retaliation from Musk. By personally insuring the board, Musk created an inherent conflict of interest.

While state statutes limit corporate fiduciaries' personal liability, they must also safeguard the ability of boards to carry out their fiduciary duties. To protect and maintain oversight duties of the directors, interest of the shareholders, and the integrity of corporations, states should expand their corporate laws to prohibit directors or officers from personally insuring the companies they serve—requiring "independent and disinterested insurers." Such amendments could include language such as:

> "Any person who would benefit from the purchase and maintenance of insurance provided by a corporation is prohibited from personally insuring the corporation."

Alternatively:

> "If a corporation elects to purchase and maintain insurance on behalf of an individual who is a director or officer of the corporation, the party in benefit of the insurance is prohibited from insuring the corporation."

By clarifying and limiting *how* companies can insure their corporate fiduciaries and what they are prohibited from doing, states would establish clear standards and guidelines to safeguard directors' fiduciary duties. It would eliminate the conflict of interests between the insurer and the insured and strengthen oversight duties by improving monitoring power of the board in order to prevent superstar CEOs like Musk from abusing their power while avoiding the consequences."

CONCLUSION

The emergence of superstar CEOs has reshaped the corporate landscape. As exemplified in recent events, Tesla's board continues to demonstrate its inability to effectively oversee Musk.[241] As custodians of corporate governance, directors are faced with balancing the benefits of a superstar CEO and the need to faithfully carry out their fiduciary duties, overseeing the CEO. This requires limiting superstar CEOs' influence and power over the board of directors.

Allowing corporate fiduciaries to personally insure directors and officers, as seen in the Musk case, present inherent conflicts of interest, undermines the

241. For example, Musk "borrowed employees from his other companies, including Tesla and the Boring Company, a tunneling start-up" to assist him at Twitter. Musk "borrowed" Tesla employees to assist him at Twitter. *See* Ryan Mac and Kate Conger, *Elon Musk Says He Will Resign as Twitter C.E.O. When He Finds a Successor,* N.Y. TIMES (Dec. 20, 2022), https://www.nytimes.com/2022/12/20/technology/elon-musk-twitter-resign.html.; *see also* Lora Kolodny, *Tesla stock has dropped more than 35% since Elon Musk first said he'd buy Twitter*, CNBC (Nov. 4, 2022, 6:37 PM EDT), https://www.cnbc.com/2022/11/04/tesla-down-35percent-since-elon-musk-first-said-hed-buy-twitter.html (missing parenthetical); Lora Kolodny, *Tesla Shares have fallen 28% since Elon Musk took over Twitter, lagging other carmakers*, CNBC (Dec. 13, 2022, 7:19 PM EST), https://www.cnbc.com/2022/12/13/tesla-stock-down-28percent-since-elon-musk-took-over-twitter.html ("Kristin Hull, Nia Impact Capital founder and a Tesla shareholder, wrote on Twitter following that: 'So many issues with the Tesla brand, when the board can't rein in the CEO'").

benefits of D&O insurance, and hinders directors' ability to effectively fulfill their fiduciary duties and manage risk allocation. State statutes play a crucial role in corporate governance and managing allocation of risk. To protect fiduciary duties and maintain oversight, it is essential for states to expand their corporate law to require the use of independent and disinterested insurers and prohibit corporate fiduciaries from personally insuring the companies they serve.