The Myth of the Director's Duty

In a corporation, management acts as agent for the owner, but they do not always have the same interests and incentives. What can we do to require--or at least encourage--people to treat other people's property with as much care as if it were their own?

The law has tried to answer this question of agency costs by developing its highest standard of behavior, the fiduciary standard, and applying it to those who hold and manage property on behalf of others. This standard applies to several different players in the process for establishing corporate behavior, including the board of directors. At least in theory, they are fiduciaries for the shareholders. And the law books are filled with attempts, some almost poetic, to define that duty. Their actions must be "held to something stricter than the morals of the marketplace," with a "punctilio of an honor the most sensitive."[5]

That there is a fiduciary standard is perhaps the most powerful myth underlying the corporate system. Why is it so important to make clear that directors must take extraordinary measures to make sure that they are protecting the rights of shareholders? The reason is our belief that those who exercise power should be accountable to those who are affected by it. We delegate authority to the directors of private companies because they are accountable to the shareholders, just as we delegate authority to government officials because they are accountable to the electorate. Accountability is what makes delegated authority legitimate; without accountability, there is nothing to prevent abuse.

This was the conundrum that almost stopped corporations before they began. Karl Marx and Adam Smith did not agree on much, but they both thought that the corporate form of organization was unworkable, and for remarkably similar reasons. They questioned whether it is possible to create a structure that will operate efficiently and fairly, despite the fact that there is a separation between ownership and control. Put another way, is there any system to make a manager care as much about the company's performance as a shareholder does? Harvard Law School's Dean Robert Clark describes this issue when he says that the major problem addressed by corporate law is how to keep managers accountable to their fiduciary duties of care and loyalty while allowing them great discretionary power over the conduct of the business.[6]

This is a key question, for both economic and public policy reasons. The separation of ownership and control leads to externalities, imposition of costs on others--including shareholders, taxpayers, and the community. For example, a company that discharges untreated effluent into a river is making the community pay some of the costs of production, through government services for clean-up or increased health care costs. A company that uses political pull at the state level to thwart a worthwhile takeover attempt is making the shareholders foot the bill, not just for the lobbying efforts, but for the lost premium, and possibly for a less competitive company. And, of course, it was the shareholders who were paying for Ross Johnson's 24 country club memberships and (at least by one account) for his dog's trip on a jet from the corporate fleet, to say nothing of the devastatingly expensive mistake of the "smokeless cigarette."

The answer to this problem was supposed to be the board of directors, elected by shareholders and acting as fiduciaries on their behalf. The board is responsible for setting overall goals and making sure they are met, for hiring the CEO and monitoring his performance, and for watching corporate management on behalf of the shareholders, to make sure that the corporation is run in their interest. That's the theory--and the myth. The reality is that directors are "merely the parsley on the fish"[7] or the "ornaments on a corporate Christmas tree."[8] As Peter Drucker put it many years ago, "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions."[9]

The Rise and Fall of the Duties of Care and Loyalty: The Morals of the Marketplace Are Good Enough

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Although the courts wanted directors to be fiduciaries, they did not want them to be hamstrung by worries that every decision would be reviewed in hindsight by a court, after the fact. So the business judgment rule was established, providing that a court will not second-guess the merits of a business decision. If it is a business decision--not outside the scope of the appropriate conduct of the corporation's affairs--and undertaken with disinterestedness, due care, good faith, and without abuse of discretion,[33] the court will not interfere.

The business judgment rule begins with the reasonable assumption that directors should not be judged in hindsight, so we should not ask that all of their decisions be the right ones. All even the strictest fiduciary standard asks is that decisions be undertaken with care, good faith, disinterestedness, and without abuse of discretion. As one court has said, "The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge."[34] In essence, the business judgment rule provides that if any rational purpose exists for the directors' or officers' decisions, they are not liable for errors in judgment, even when the decisions turn out to be wrong.

The business judgment rule can be traced as far back as 1829.[35] In that case, the court seems to have held that directors have no particular duty to try to find out if the company is being managed honorably--remarkably consistent with the claims made today by lawyers defending directors of failed banks and savings and loans. Although it goes pretty far, even by today's standards, the reasoning in the decision reflects another set of agency costs, those created as the board sets overall policy and leaves it to management to carry out. The business judgment standard was refined over the next century and a half, and it has recently been more vigorously redefined, as courts have been forced to apply it to grapple with the more complex issues of corporate control.

In general, fiduciary duty has two components: the *duty of care* and the *duty of loyalty*. We will begin with the fiduciary duty of care. It contains two elements: *alertness* to potentially significant corporate problems and *deliberative decision making* on issues of fundamental corporate concern. The duty of care is generally interpreted as a "reasonable director standard." In other words, we expect more from a director than from a simply "reasonable man"; we expect the director to behave reasonably according to the experience and expertise a director should have. We might not expect a reasonable man to be familiar with generally accepted accounting principles or earnings per share, but we do expect that of a director.

The Duty of Care

A director shall discharge his duties as a director, including his duties as a member of a committee:

1. in good faith
2. with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and
3. in a manner he reasonably believes to be in the best interests of the corporation .

The Model Business Corporation Act [Sec. 8.30(a)]

Reasonableness varies according to the circumstances. A director who is a lawyer or an accountant is expected to bring his expertise to bear on the issues presented to the board and thus may be held to a higher standard than a director who does not have that training. Corporate officers who are also directors are sometimes held to an even stricter standard, because they know more about the day-to-day operations of the company. Similarly, directors of large companies are sometimes held to a stricter standard than directors of small companies, because directors of large companies are expected to be more familiar with complex corporate finance and governance issues.

There is no way to establish a clear standard for the duty of care; courts must examine the facts of each case. It is the duty of care that has been most troubling to corporations, and the one that has been cut back the most by judicial opinions (the business judgment rule) and state legislatures (limiting liability and permitting indemnification). If one examines the cases that apply fiduciary standards to boards of directors, it is difficult to connect them to the high principles of the decisions quoted previously.

In theory, the rule can be seen as another way of determining "reasonableness." Reasonableness generally relates to process. What was the basis for the decision? What experts were consulted? What research was done? But in practice, many people believe that the courts (especially the most recent decisions of the Delaware courts) have used the business judgment rule to virtually eliminate any real duty of care.
The business judgment rule gives directors a rebuttable presumption of correctness, meaning that anyone challenging a business decision has the burden of proving that it violated fiduciary standards. The courts will go to the greatest possible lengths to defer to directors' business judgment, unless there is a clear showing of fraud or bad faith.

A woman who "never made the slightest effort to discharge any of her responsibilities as a director" was found to have violated the duty of care in *Francis v. United Jersey Bank.*[36] She had never attended a single board meeting or read any of the financial statements, which clearly revealed that her sons (corporate officers) were embezzling funds. In *Hoye v. Meek,*[37] a president and CEO who stopped attending board meetings after he retired and moved away was found liable for over $1.4 million. But, as Woody Allen said, 80 percent of life is just showing up, and directors who do show up get a lot of deference.

In *Shlensky v. Wrigley,*[38] a court upheld the decision not to install lights in Chicago's Wrigley Field, despite the fact that lights for night games were the industry standard and that the decision resulted in loss of revenues from attendance, concessions, and broadcast rights.

The business judgment rule has even been applied in cases of clear shareholder opposition, as in *American International Rent A Car v. Cross.*[39] It became clear at the annual meeting that the shareholders would not support a proposed bylaw amendment. The directors called a recess and adopted the amendment themselves. The court acknowledged that the board's action "had the effect of withdrawing a vote from the stockholders," but that alone did not "automatically override" the other factors (such as the need for additional capital) that the board considered in deciding to approve the amendment.

Courts do not always allow directors to thwart shareholder actions. Directors who try to change the rules on voting find that "in circumstances where corporate fiduciaries appear to have acted out of self-interest, it is particularly appropriate to give scrutiny to the question whether they discharged their duty of the exercise of care."[40]

When Blasius Industries attempted to take over and restructure Atlas Corp. in 1987, it proposed a consent solicitation to put eight Blasius candidates on the board. Atlas expanded its board from seven to nine members, appointing two new members to the board to ward off the attempt. In *Blasius Industries, Inc. v. Atlas Corp.,*[41] the plaintiffs charged that the action by the Atlas directors was "motivated solely by an attempt to retain control of the corporation and violated the directors' duty of good faith." The Delaware Chancery Court disagreed that self-interest was involved, stating that the Atlas board found the Blasius restructuring proposal faulty and that the bond's action was "a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization that it feared, reasonably, could cause great injury to the company."[42] The court did, however, refuse to defer to the business judgment of directors who interfered with the voting rights of shareholders, finding that "even though defendants here acted on their view of the corporation's interest and not selfishly, their December 31 action constituted an offense to the relationship between corporate directors and shareholders."[43]

The court also added that "the deferential business judgment rule does not apply to board acts taken for the primary purpose of interfering with a stockholder's vote, even if taken advisedly and in good faith."[44] Although the plaintiffs lost their second suit, alleging that the consent election results were improperly computed, Blasius represents a milestone in defining board responsibility to the shareholders' right to vote.

The business judgment rule does not protect directors if their "sole" or "primary" purpose is self-perpetuation. But that level of protection is not consistent. The takeover battles of the 1980s subjected a lot of defensive maneuvers to "business judgment" scrutiny, and at first the courts tried to limit its application when management's interest might conflict with the shareholders' interest. Later, as these decisions led corporate managers to consider changing to another state of incorporation, the courts quickly reversed this trend.[45]

The Death of the Duty of Care, Part II: Limited Liability and Indemnification

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Cases like *Van Gorkom* triggered huge increases in insurance premiums for directors if, in fact, coverage was available. Increasingly, companies confronted an inability to purchase E&O (errors and omissions) insurance for fiduciaries at any price. To protect themselves, directors passed bylaw amendments limiting the amount for which they could be held liable. First, of course, state legislatures had to authorize such caps on liability. Delaware did so immediately after the Van Gorkom decision, and other states soon followed suit, in yet another example of state legislatures accommodating managers. A number of states have adopted very broad laws limiting the liability of directors, even for negligent acts. This effectively eliminates a duty of care. Nevada, New Jersey, and Virginia permit limitations on the monetary liability of officers, in addition to directors. New Mexico even allows limited liability for gross negligence. Some states allow the corporation to cover a director's legal expenses, plus damages, even if the court finds that the director violated his duty. In states where indemnification provisions are overly broad, a significant problem arises since shareholders who challenge directors are in effect picking their own pockets. An unsuccessful defense by an indemnified director can lose the shareholders more through recovery and reimbursement than they had originally suffered in damages.

The Death of the Duty of Loyalty, Part II: Stakeholders

A previously unheard-of doctrine, the stakeholder concept, has recently taken strong hold in corporate America. In essence, it says that corporate directors owe a duty to a host of constituencies beyond shareholders: local communities, employees, suppliers, creditors, and others. This is in contrast to the traditional model of the publicly held corporation in law and economics, which says that corporate directors serve one constituency their shareholders. As James J. Hanks, Jr. of Weinberg & Green said, it is "an idea whose time should never have come."[90]

The stakeholder theory is now being applied in at least three different contexts: state antitakeover legislation, public pension fund investment policy, and corporate policies in responding to takeovers.

Traditionally, one of the most important aspects of the corporate form was the directors' and officers' absolute fiduciary duty of loyalty to the shareholders. As Louis Lowenstein, head of Columbia University's Institutional Investor Project, has said, shareholders should come first, "Not because you like them or hold them in high esteem, but because if you don't, there is no bottom line, no way to measure efficiency.... The system collapses if shareholder interests are not primary"[91]

In the past couple of years, a number of states have adopted "stakeholder laws" to permit a board of directors to consider the impact of any proposed action on its employees, customers, suppliers, creditors, and communities, plus any other factors it deems pertinent, in addition to the impact on shareholders. Typically, these statutes "apply generally to decisions by the Board, including decisions with regard to tender offers, mergers, consolidations and other forms of business combinations."[92] The early state laws of this kind make this provision available for adoption by corporations, with shareholder approval. And most of them make it clear that the board's authority is completely discretionary, and no stakeholder constituency is entitled to be considered.

It has always been permissible, even required, for directors and managers to consider the interests of stakeholders, in the context of the interests of shareholders. Courts have upheld a corporation's right to donate corporate funds to charities, for example, as it was in the corporation's long-term interests. As the American Bar Association Committee on Corporate Laws pointed out, "[T]he Delaware courts have stated the prevailing corporate common law in this country: directors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders."[93] The committee also noted that *Unocal,* which enabled directors to analyze the effects of a potential takeover on a variety of factors, including constituencies, does not suggest "that the court intended to authorize redress of an adverse impact on a non-shareholder constituency at the expense of shareholders."[94] Although it is useful (and cost-effective) to consider the best way to meet the admittedly competing needs of the company's diverse constituencies, it is an oversight to fail to make clear that the shareholders must have first priority.

No court, no legislature, and no shareholder has ever claimed that the duty of loyalty prevented consideration of other constituencies. Indeed, directors who fail to consider the interests of customers, employees, suppliers, and the community fail in their duty to shareholders; a company that neglects those interests will surely decline. In the past, these proposals have been occasionally submitted by shareholders, who want the board to undertake a more comprehensive analysis of proposed actions. But "stakeholder" language, in legislation or in corporate charters, can be camouflage for neglect, whether intentional or unintentional, of the rights of shareholders.

The danger is in allowing corporate managers to make policy trade-offs. That should be left to those who have another kind of accountability--through the political process.

F. A. Hayek posed the alternatives this way:

> So long as the management has the one overriding duty of administering the resources under its control as trustees for the shareholders and for their benefit, its hands are largely tied; and it will have no arbitrary power to benefit this or that particular interest. But once the management of a big enterprise is regarded as not only entitled but even obliged to consider in its decisions whatever is regarded as the public or social interest, or to support good causes and generally to act for the public benefit, it gains indeed an uncontrollable power--a power which could not long be left in the hands of private managers but would inevitably be made the subject of increasing public control.[95]

The Business Roundtable seems to agree. In its 1990 report, *Corporate Governance and American Competitiveness,* it contrasts political and "economic" organizations. "Legislative bodies . . . represent and give expression to a multiplicity of constituent interests. Our political system is designed to create compromises between competing interests, to seek the broad middle ground.... This system of governance would be fatal for an economic enterprise."[96] Yet that is just what the stakeholder initiatives it supports would require.

In 1990, Pennsylvania risked the consequences Hayek warned about when it adopted the notorious Act 36 of 1990, which went far beyond other stakeholder laws in moving beyond consideration--a rather benign concept--to one with more legal bite: Directors may consider "to the extent they deem appropriate" the impact of their decisions on *any* affected interest. They are not required "to regard any corporate interest or the interests of any particular group . . . as a dominant or controlling interest or factor" as long as the action is in the best interest of the corporation. [97] In the context of a potential or proposed change-of-control transaction, a determination made by disinterested directors (those not current or former employees) will be presumed to satisfy the standard-of-care requirement unless *clear and convincing* evidence proves that the determination was not made in good faith after reasonable investigation. This means, as a practical matter, that directors cannot be held liable for what they do, absent some element of self-dealing or fraud. This provision required no shareholder approval; it was immediately applicable to all companies incorporated in Pennsylvania, unless they opted out within 90 days.

The anti-shareholder bias of the bill was made clear during the campaign to pass the bill. In December 1989, a "fact sheet" sent to state legislators from the Pennsylvania Chamber of Commerce, which cosponsored the bill with the local AFL-CIO, contained the statement that the bill would "reaffirm and make more explicit the time-honored (and current) principle that directors owe their duties to the corporation, rather than to any specific group such as shareholders."[98] The new law does not say that directors are free to place greater importance on factors other than long-term profit maximization, but to give it any other interpretation is to violate the foremost principle of statutory construction and assume that the legislature intended its language to have no effect.

It did have an effect, though perhaps not what the legislature intended. By October 15, 1990, [99] companies--nearly 33 percent of the state's publicly traded companies--had opted out of at least some of the provisions of the bill. Over 61 percent of the Fortune 500 incorporated in Pennsylvania opted out, as did over 56 percent of those in the S&P 500. So massive was the stampede out of Pennsylvania Act 36 that a *Philadelphia Inquirer* editorial noted: "These business decisions make it all the more clear that the law was crafted not in the best interest of the state's businesses, but to protect Armstrong World Industries Inc. and a few other companies facing takeover attempts."[100] A company spokesman for Franklin Electronics Publishers stated that its board "believes that the Pennsylvania legislation runs counter to basic American principles of corporate democracy and personal property rights."[101]

Apparently, the market agreed. Jonathan M. Karpoff and Paul M. Malatesta at the University of Washington School of Business found that from October 12, 1989 (the date of the first national newswire report of the bill), through January 2, 1990 (when the bill was introduced in the Pennsylvania House), the shares of firms incorporated in Pennsylvania underperformed the S&P 500 by an average of 6.9 percent. [102] Another study, by Wilshire Associates, linked enactment of the Pennsylvania antitakeover law with a 4 percent decline in stock prices of companies incorporated there. The study of Pennsylvania companies with a stock market capitalization greater than $5 million charted 63 companies from January 1, 1989, through August 15, 1990.[103]

One important question is how the "best interests of the corporation" differ from the "best interests of the shareholders." Scholars have debated for decades just what a corporation is, but whether it is a "bundle of contracts" or an "imaginary person," it seems fair to envision a hypothetical long-term shareholder, such as the beneficial owner of most institutional investor securities, as the ultimate party at interest. This allows all other interests to be factored in. But without a clear, direct, and enforceable fiduciary obligation to shareholders, the contract that justifies the corporate structure is irretrievably shattered.