CORPORATE LAW

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poration and are two of its directors; Barbara and her spouse own the other half of the stock and are the other two directors. Andy is the president of the company; Barbara is the vice president, secretary, and treasurer. Barbara wants to bring a suit in the name of Excellent Corporation against Chumly, Andy's son-in-law who was made a sales employee of the corporation at Andy's insistence. The claim is that Chumly wrongfully converted corporate assets to his own use. Andy and his spouse object to the bringing of the litigation. Chumly defends on the ground that Barbara does not have authority to initiate the suit.

In cases like this, courts have seemed to accept the issue as being one of authority. They have purported to find it relevant whether the suit was against an insider or not (a suit against Andy himself would presumably be easier to permit than one against Chumly), and whether the board of directors actually voted that the suit not be brought (in which case, apparently, their decision would be respected) or whether the board was deadlocked or did not formally vote on the matter at all (in which case the suit might proceed despite the fact that a majority of directors does not affirmatively support the bringing of a suit).

Real issue is conflict of interest

What is really at issue in these cases, of course, is not primarily a question of authority, but a conflict of interest. It is clear that *ordinarily* the board of directors may vote to preclude the bringing by the corporation of a suit and may thus override the corporate president. It is also clear that corporate presidents ought to be able, without explicit board approval, to cause their corporations to bring a variety of lawsuits in the *ordinary* course. The trouble arises — and the case therefore becomes *non*ordinary and thus legitimately subjected to *different* rules — where the directors have mixed motives. Andy and his spouse may have opposed the lawsuit in our example, not because they believe it would not be in Excellent's best interest, but because they want to protect their son-in-law. Indeed, the conversion by Chumly of Excellent's assets may actually have been in their own interest if they were intending to make a substantial gift to Chumly and his wife. For a dollar taken by Chumly from the company only costs them 50 cents (the other half coming from the stockholder claims of Barbara and spouse), whereas a dollar from their own assets would cost a dollar. In this kind of situation, it is not surprising that courts find a way to let the lawsuit proceed — even despite apparently contrary precedent.[24] What is surprising is that their reasoning seems confined to the language of presumptive

[24]See, for example, how the court in *Rothman & Schneider*, which resembles the hypothetical in the text, dealt with the prior opinion in *Sterling Industries*. (Both cases are cited in footnote 23 supra.)

or inherent authority. It might be better for courts to simply say that, when director opposition to the bringing of a corporate suit is infected with a conflict of interest, any officer acting in good faith may initiate the suit.

§3.4 *The Duty of Care Versus the Business Judgment Rule*

Duty of care

Nowhere is the tension between the policies of giving managers ample discretion and trying to keep them accountable as obvious as in the cases invoking the duty of care, the business judgment rule, or both. Statutes and case law say that directors and officers owe their corporations a duty of care: They must exercise that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances.[1] At times, some authorities have applied the stricter formulation that the director or officer must act as a reasonably prudent person would act in the conduct of his own affairs.[2] It is doubtful whether this difference in standard has affected the outcome of cases. In any event, by analogy to the duty of care concept used in tort law, violation of the director's or officer's duty of care is frequently described as negligence.

Business judgment rule (BJR)

In contrast to this worrisome doctrine, the mere mention of the business judgment rule brings smiles of relief to corporate directors. In a sense, the business judgment rule is just a corollary of the usual statutory provision that it is the directors who shall manage the corporation.[3] The rule is simply that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment — even for judgments that appear to have been clear mistakes — unless certain exceptions apply. Put another way, the rule is "a presumption that in making a business decision, the directors of a corporation acted on an

§3.4 [1]MBCA §8.30(a) (director's duty to act in good faith, with due care, and in manner he reasonably believes to be in the best interests of the corporation); Cal. §309; N.Y. §715(h); Guth v. Loft, Inc., 5 A.2d 503 (Del. Ch. 1939), aff'd, 19 A.2d 721 (Del. 1941). See generally American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, tent. draft no. 3 (April 13, 1984), at 1-84 (part on duty of care and business judgment rule) (hereinafter cited as ALI Corp. Gov., t.d. no. 3).

[2]See Comment to N.Y. § 717, "Duty of Directors and Officers" (McKinney 1963); former Pa. Bus. Corp. Law §408, discussed in Selheimer v. Manganese Corp. of America, 224 A.2d 634 (Pa. 1966).

[3]Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

informed basis in good faith and in the honest belief that the action was taken in the best interests of the company."[4]

Challenges not precluded by BJR

By any reckoning, the kinds of actions and judgments not protected by the business judgment rule are extremely important, although courts do differ in their formulation of the exceptions. Some say that no challenge to the directors' judgments will be considered on the merits unless the judgment in question was tainted by fraud, conflict of interest, or illegality;[5] others say, unless the alleged defect in the directors' judgment rises to the level of fraud;[6] still others, unless it rises to the level of gross negligence.[7] The basic idea of the fraud and conflict of interest exceptions is that, when directors are shown to have been trying to further their own personal ends, or to have been strongly tempted to bias the terms of a transaction in their own interest, their judgments are not really within the class of discretionary exercises of power on behalf of the corporation that we want to protect. The idea behind the illegality exception is that shareholders' derivative suits can be a useful supplement to the enforcement activities of public prosecutors and regulatory agencies.

Tension between duty of care and BJR

At first blush, the business judgment rule seems to take away much of the force of the duty of care. Virtually all courts agree that directors will not be held liable for "honest mistakes" of judgment. But most of them also say, in effect, that directors cannot act negligently (or in a grossly negligent way). Is the duty of care simply gobbledygook, then, or a mere exhortation rather than an enforceable legal duty? Linguistically, one can construct an accommodation of the two ideas that makes them *logically* consistent with each other. Here is one such formulation: the directors' business judgment cannot be attacked unless their judgment was arrived at in a negligent manner, or was tainted by fraud, conflict of interest, or illegality. Put another way (as courts have sometimes put it), the business judgment rule presupposes that reasonable diligence lies behind the judgment in question.[8] But making the concepts *practically* consistent is another matter: drawing the line between an honest mistake and a negligent one can be difficult.

[4] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). See also Pogostin v. Rice, 480 A.2d 619 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Gimbel v. The Signal Companies, Inc., 316 A.2d 599 (Del. Ch. 1974), aff'd, 316 A.2d 619 (Del. 1974).

[5] E.g., Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. 1968). See also Maldonado v. Flynn, 413 A.2d 1251, 1255-1256 (Del. Ch. 1980), rev'd, 430 A.2d 779 (Del. 1981).

[6] Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

[7] Bucyrus-Erie Co. v. General Prod. Corp., 643 F.2d 413 (6th Cir. 1981); see also Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). Note that decisions such as this do *not* mean to imply that the business judgment rule precludes a suit based on fraud or self-dealing by the directors. The "gross negligence" formulation is concerned only with adjusting the business judgment rule to the fiduciary duty of care; the duty of loyalty (see chapter 4) is another matter.

§3.4.1 Case Law Development of Duty of Care

Liability for inactive directors

Violation of the duty of care might arise from inactivity, from grossly negligent behavior, or from simple negligence. The distinction might be compared to three levels of bad acting: going on stage but failing to say one's lines, because one didn't even try to memorize them; going on stage and murdering one's lines, because one learned the lines poorly; and going on stage and saying the lines correctly but doing a bad job of acting, because one lacks talent or did not rehearse enough. As a general matter, most successful attacks on directors resemble the first level, that is, a simple failure, after having become a director, to engage in the basic activities of that role. Directors have been found to violate their duty of care when they failed to attend meetings, to learn the basic facts about the business of the corporation, to read a reasonable quantity of reports, to seek needed help when a danger signal appeared, or when they have otherwise neglected to go through the standard motions of diligent behavior.[9] The

[8] The classic statement of this point is in Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (S. Ct. 1944). A representative recent case is Lussier v. Mau-Van Development, Inc., 667 P.2d 804, 817 (Hawaii Ct. App. 1983). See also ALI Corp. Gov., t.d. no. 3, at 56-69 (discussing prerequisites to the protection afforded by business judgment rule:

(1) a conscious exercise of judgment;
(2) an informed decision;
(3) good faith and no self-interest; and
(4) a rational basis).

[9] A good example is given by Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981), where a director and the largest shareholder of a corporation, after the death of her husband, took no interest in the company, thus giving her sons the opportunity to embezzle corporate funds. (Plaintiffs were trustees in bankruptcy of the corporation and therefore represented its creditors. Note that in an insolvent corporation creditors acquire the status of residual claimants and can enforce duties principally designed for the benefit of shareholders.) The court was unimpressed by the claims that she was old, depressed, alcoholic, and ignorant of business affairs; such a person should not become a director. (In fact, since the trustees were simply trying to get at the assets in the estate of the deceased husband, who was the prime mover in the corporation, the holding was not as hardnosed as it seems.)

From a planning perspective, the opinion in *Francis* offers useful guidelines as to what every director should do:

(1) get a rudimentary understanding of the business;
(2) keep informed about the corporation's activities;

courts often talk tough in these cases and warn so-called figurehead directors — those who become directors at the request of spouses or friends and as an "accommodation" — that the law will not excuse them for failing to behave like real directors. Even here, however, the inactive or naive director sometimes gets off the hook.[10] And in other cases, the undoubted negligence of directors may not result in liability if the plaintiff cannot show that the negligence proximately caused damages to the corporation.[11]

Liability for simple negligence rare

Cases in which active directors are nevertheless held liable are rarer. In fact, the total number of reported cases in which derivative actions against directors of nonfinancial corporations were actually won on the merits on the basis of simple negligence uncomplicated by any fraud or self-dealing is small. Professor Bishop, in a search of cases over several decades, found only four.[12] To be sure, the number of decided cases does not tell the whole story, since most suits against directors, whether based on negligence or something else, are settled, and since all the cases brought, if publicized within the corporate world, may terrify other directors into being more careful. But the case law experience must still lead us to wonder whether the courts are serious when they say directors may be held liable for negligence.

Cases sometimes suggest self-dealing

This feeling is reinforced when we examine some of the better known cases in a critical way. Not infrequently, the facts suggest that the directors were actually being sued and held liable because of wrongful self-interested conduct — for a violation of their fiduciary duty of *loyalty* — and the courts' talk about duty of care is simply a way of letting the plaintiffs win without having to prove all the elements of a wrongful conflict of interest transaction.[13] (Such proof may be difficult and the evidence may be within the defendants' control.)

(3) engage in "a general monitoring of corporate affairs and activities";
(4) attend board meetings regularly;
(5) review financial statements regularly; and
(6) make inquiries into doubtful matters, raise objections to apparently illegal actions, and consult counsel and/or resign if corrections aren't made.

[10] See, e.g., Allied Freightways, Inc. v. Cholfin, 91 N.E.2d 765 (Mass. 1950) (passive accommodation director — the wife of another director — escapes liability under gross negligence standard).

[11] See Barnes v. Andrews, 298 F. 614, 616-617 (S.D.N.Y. 1924) (Learned Hand, J.).

[12] Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078, 1099-1100 (1968). See also Cohn, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 Tex. L. Rev. 591 (1983). An important later case, Smith v. Van Gorkom, will be discussed shortly.

[13] See Bishop, note 12 supra, at 1100, for a similar analysis of the Selheimer case cited in note 2 supra. On its face it is a duty of care case, he says, but "the facts are heavy with the odor of self-dealing. . . ."

Example of *Litwin v. Allen*

In *Litwin v. Allen*,[14] for example, the directors of the Guaranty Trust Company had approved the purchase of certain convertible debentures with an option in Allegheny Corporation, the seller, to repurchase. The directors were among the most experienced risk assessors in the investment or commercial banking communities. Yet a New York court found that their approval of the bond purchase was negligent. Specifically, it found that the entire arrangement was so improvident, so risky, so unusual and unnecessary as to be the contrary to fundamental conceptions of prudent banking practice.[15] But the court's reasoning is not persuasive, even on its own terms.

First, the fact that a transaction is unique can hardly be a basis for finding that it is negligent to undertake it.

Second, the transaction was not really very unique. A repurchase agreement of the sort involved simply means that in effect the Guaranty Trust Company was making a *secured loan* to the Allegheny Corporation. In fact, the transaction clearly was a substitute for a loan, which Allegheny Corporation was prohibited from accepting directly because of a borrowing limitation in its charter.

Third, it is of course possible that directors could be negligent because they approve a loan that is excessively risky, or more precisely, that has a risk that is excessive in relation to the risk that would be incurred in other investments with comparable expected return. But the court in fact made no serious inquiry into this question, which in any event would seem to fall clearly within the ambit of the business judgment rule.

Clue to the result

The clue as to why the court resorted to such a formalistic and erroneous application of the duty of care is that the Guaranty Trust Company was an affiliate of, and controlled by, the J. P. Morgan Company, and the Allegheny Corporation was part of the so-called Van Sweringen business empire. J. P. Morgan and Company and all its affiliates together had quite an investment in the Van Sweringen empire, and a decline in the value of Allegheny stock was threatening the stability of all these investments. Thus, although the risk inherent in the debenture purchase transaction was the potential decrease in the value of the debentures, a risk that would be borne solely by Guaranty Trust Company, the potential benefit was the avoidance of the even greater loss of the total investment of the J. P. Morgan affiliates in the Van Sweringen empire, a benefit that would

[14] 25 N.Y.S.2d 667 (S. Ct. 1940).

[15] Id. at 699.

accrue to various parts of the Morgan complex. In other words, the transaction could be seen as one that was not being effected *for the best interest* of the Guaranty Trust Company. It was a transaction in which there was an apparent conflict of interest between the injured corporation and other companies that controlled it.

Why talk negligence instead of self-dealing

Why didn't the court deal with the conflict of interest problem directly? The court's own words suggest the answer: "There is *no evidence* in this case of any improper influence or domination of the directors or officers of the Trust Company or of the Guaranty Company by J. P. Morgan & Co. . . . "[16] Evidence of how Morgan's top management might have influenced the directors of the Trust company would be very difficult for the plaintiffs, who were shareholders of the Trust Company, to get. In addition, evidence needed to show *wrongful* self-dealing, that is, evidence about the actual riskiness, expected return, and hence true value of the convertible debentures, would have been equally difficult to present in a conclusive way. One may suspect, then, that the court's twisted reasoning toward the conclusion that there was a violation of the duty of care was simply a way of giving the plaintiffs a break in a situation where equity seemed to require it.

Example of *Smith v. Van Gorkom*

In view of this case law background, the Delaware Supreme Court's controversial 1985 decision in *Smith v. Van Gorkom*[17] is quite striking. Shareholders brought a class action seeking rescission of a cash-out merger of their company into another or, in the alternative, damages from defendant members of the board of directors whom they charged with breach of their duty of care in approving the merger. The court of chancery held for defendants on the grounds that the directors were protected by the business judgment rule and the shareholder vote on the merger was fully informed. But the Delaware Supreme Court reversed and directed judgment for the plaintiffs. It held that the board's approval of the merger agreement wasn't the product of an informed business judgment, that the board's subsequent curative efforts were ineffectual, and that the board didn't deal with "complete candor" with the shareholders.

Duty to become informed

Perhaps the key legal proposition of the case is that, though the business judgment rule does create a presumption that the board's decision was an informed one, plaintiffs can rebut the presumption (and they did, in the *Van Gorkom* case) by showing that the directors failed to meet their duty to inform themselves "prior to making a business decision, of all material

[16] Id. at 694 (emphasis added).
[17] 488 A.2d 858 (Del. 1985).

information reasonably available to them."[18] The business judgment rule doesn't shield unadvised judgments. This duty to become informed is, of course, an aspect of the duty of care. The court stated that the concept of gross negligence was the proper standard for determining whether the board's business judgment was an informed one.

Factors in the result

The opinion in *Van Gorkom* is heavily oriented to the facts. Of obvious importance to the result was the fact that the directors approved the merger at a relatively brief, quickly called meeting upon the basis of a 20 minute oral presentation by Van Gorkom, the chairman and chief executive officer, without having or reviewing the merger documents and without having or calling for a serious valuation study, either by directors and officers or by an outside investment banking firm. Of apparent importance to the result (on my reading) is the circumstance that Van Gorkom seems to have been a rather autocratic leader who acted and made decisions in a solitary rather than a consultative fashion, without soliciting substantial discussion with and feedback from the company's top officers and board members. The court apparently thought it was an abdication of duty for the other directors to submit to this kind of domineering leadership.[19] The court also discounted the significance of the fact that the cash-out merger price was at a premium over the previous market price of the company's stock, since the merger price was not based on any serious effort to value the company. It also discounted the fact that the merger proposal was subjected to a market test (the directors reserved time in which to consider other, better offers), since the test was "virtually meaningless" in light of the terms and time limitations governing it. And it rejected the defense that the directors were highly sophisticated and experienced persons (they were) on the ground that their general expertise did not give them a license to shoot from the hip in such an important transaction.

§3.4.2 Duty of Care as Responsibility for Systems

The monitoring model

In large corporations, the directors' role seems confined in practice to giving advice and counsel to the president, acting in crisis situations, and reviewing broad policy decisions. Commentators have used this fact as

[18] Id. at 872, quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[19] Recall our discussion earlier in this chapter of Baldwin v. Canfield. Of course, one could take the view, implicit in the *Van Gorkom* dissent, that strong leadership, quick action, and avoidance of committees and red tape make the business world work better or, at the least, that it should be permissible for directors of particular companies to allow them to be run under such a philosophy.

part of an argument for explicit legal recognition of a "monitoring" model of the board, plus reforms to encourage real monitoring by directors of officers' performance.[20] There has been resistance to the policemen image conjured up by the monitoring model, and even counterargument to the effect that there is a substantial role for the board of the large modern corporation to play in substantive business decision making.[21] But even under the latter approach, directors would principally make strategic decisions rather than direct day-to-day operations.

Nature of monitoring duties: the *Allis-Chalmers* case

A question raised by the inevitably general, even detached, role of the board in very large corporations is, What is the nature of the directors' responsibility for the misconduct of operating level managers and employees? This question was presented to the Delaware Supreme Court in *Graham v. Allis-Chalmers Manufacturing Co.*,[22] a case arising out of the notorious electrical equipment price-fixing conspiracy.[23] The Department of Justice obtained indictments charging criminal violation of the federal antitrust laws by the price fixing activities of various middle level executives of Allis-Chalmers and other companies in the heavy electrical equipment industries. Pleas of guilty were entered by the corporation and certain of its employees, who went to jail. Certain shareholders brought a derivative suit in the Delaware courts to recover, from the directors and from nondirector employees, damages Allis-Chalmers was claimed to have suffered by reason of the antitrust violations and the ensuing imposition of penalties. The Delaware Supreme Court confirmed a Vice Chancellor's ruling that the defendant directors were not liable. It characterized the plaintiffs' proposed interpretation of the duty of care as calling for an affirmative duty to install a system of internal monitoring of the legality of employees' conduct, and it rejected the idea.

> The precise charge made against these director defendants is that, even though they had no knowledge or any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a *system of watchfulness* which would have brought such misconduct to their attention in ample time to have brought it to an end. However, . . . directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but 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.[24]

[20] The major pioneer in developing this model is Professor Melvin Eisenberg. See his The Structure of the Corporation: A Legal Analysis (1976). See also Dent, The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care, 61 B.U.L. Rev. 623 (1981).

[21] Haft, Business Decisions by the New Board: Behavioral Science and Corporate Law, 80 Mich. L. Rev. 1 (1981).

[22] 188 A.2d 125 (Del. 1963).

[23] See Geis, On White-Collar Crime: The Heavy Electrical Equipment Antitrust Cases of 1961, in Corporate and Governmental Deviance: Problems of Organizational Behavior in Contemporary Society 123 (M. Erman & R. Lundman eds., 2d ed. 1982).

The court's arguments

In reaching this result, the court was influenced by several factors. Allis-Chalmers' large size — its 31,000-plus employees, 24 plants, and 145 sales offices, for example — confined the directors' role, according to the court, to "the broad policy decisions." Its policy of decentralizing decision making authority was also noted by the court, which apparently thought it to be a good idea and somehow inconsistent with top-down monitoring systems. An internal monitoring system also connotes, to some persons, unwholesome snooping, a gratuitous insult to the dignity and integrity of corporate employees, and a business policy that may create more costs in terms of bad employee morale than it is worth. All of this may be implicit in the court's exaggerated rhetorical description of the plaintiff's proposal as being to establish a system of "espionage." And finally, the directors were entitled to rely in good faith upon books of account or reports made by officers, as well as upon other corporate records, under a statutory provision now appearing as Section 141(e) of the Delaware General Corporation Law, which has analogues in MBCA Section 8.30(b) and the statutes of other states.[25]

Rebuttals

Of course, none of these considerations really clinched the court's conclusion. The fact that giant size confines directors to broad policy decisions is beside the point. A decision by the directors ordering the corporation's legal counsel to design and implement a systematic legal compliance or legal audit program, as it is sometimes called, *would* be a broad policy decision. No one expects the directors to design or implement the program themselves. Furthermore, a policy of decentralizing decision making authority is not in fact inconsistent with a policy of monitoring whether employees obey the law, any more than it is inconsistent with internal accounting controls designed to make sure that employees do not steal the company's inventory or cash. A monitoring system might cause discomfort to employees who do not like to be watched. But it is a discomfort that may necessarily attend all efforts at supervision and control, and the cost seems warranted in light of widespread reports of corporate illegality. Moreover,

[24] 188 A.2d at 130 (emphasis added).

[25] E.g., Cal. §309; N.Y. §717.

no rational employee should feel personally insulted by an impartial system of controls applicable to virtually all of the corporation's employees. And finally, the statutory provisions about reliance upon corporate records are qualified by the condition that reliance must be in good faith. The good faith proviso can be interpreted to mean that directors may not rely when they spot something they should regard as suspicious or inadequate about the particular records or reports in question or about the corporation's system of procedures for generating records and reports. (In any event, policy makers might well consider clarifying the statutes to spell out this latter interpretation.)

A *judicially* required legal compliance program?

Despite the weakness of its reasoning, the Delaware court did seem to reject a general affirmative duty on the part of directors of large corporations to order implementation of a proactive legal compliance *system* of some sort and restricted their investigative duties to those arising when some suspicious *triggering event* occurs. Why?

Arguments against the idea

Perhaps a deeper motivation for the court's holding is to be found in the belief that the net result of the middle managers' price fixing activities actually was beneficial to the company and its shareholders. At least this may have been true prospectively, at the times when these managers made the relevant decisions. It may even have remained true after the discovery and the ensuing law suits! After all, undiscovered antitrust violations hurt consumers but help the offending corporation and its shareholders. Whether a violation is likely to be discovered and sanctioned, and if so, whether the risk is worth running, are questions of business judgment. Given these assumptions, the directors' institution of an effective legal compliance program would amount to an act that was wasteful, rather than careful, skillful, and diligent, as regards the interests of the corporation and its shareholders. No court would countenance a directorial decision ordering middle managers to violate important criminal statutes, of course, or a deliberate refusal of the directors to do anything about known continuing violations. But a court might think that a decision to have corporations incur the cost of creating a non–profit-maximizing legal compliance program should be expressly compelled by the legislature that enacted the laws whose compliance is in question, or at least left to management's discretion, rather than judicially made by reading an affirmative, specific duty to advance the public interest into *corporate* law duties whose historical purpose has been to ensure managerial regard for the interest of shareholders. If antitrust policies are so important, and if Congress thinks that the antitrust monitoring and enforcement devices that it explicitly legislated are inadequate, it has the option of deciding that a new law requiring corporate directors to monitor antitrust compliance

would be a good way to help solve the problem. According to this argument, *judicial* creation of enforcement systems for regulatory statutes is a task that should be approached with caution, especially when the statute is federal and the court is a state court.

Internal accounting controls are a different matter

If this reading of the motivations behind the *Allis-Chalmers* result is correct, it would mean that the Delaware Supreme Court might yet find that directors of large corporations can violate their duty of care by failing to insure the existence of a system of *internal accounting controls*. Not having such a system might very well be thought to result in a risk of injury to shareholders that no reasonable director would normally incur. In so finding, the court would not be mandating an enforcement system for a regulatory statute aimed at protecting nonshareholder interests. Therefore, it would not contradict the spirit of *Allis-Chalmers*.

Federal requirement of such controls

Ironically, public corporations are now subject to federal statutory requirement that they devise and maintain a system of internal accounting controls. The requirement grew out of the foreign bribery scandals of the mid-1970s. It came to light that hundreds of U.S. corporations, through employees and agents, had made bribes of many millions of dollars to foreign government officials and politicians, in hopes of obtaining governmental purchase orders and regulatory favors that would enhance their business volume and profit.[26] The main concern of most investigators and reformers was not with corporate shareholders, despite some lip service in their direction, but with the impropriety of letting U.S. corporations contribute to the corruption of foreign governments. In many cases, the bribery may have helped corporate profits.

Foreign Corrupt Practices Act

Congress's response was the Foreign Corrupt Practices Act of 1977.[27] The key provision was one making it unlawful for U.S. corporations or their directors, officers, or agents (1) to make a bribe to a foreign official or foreign political party or party official or (2) to make payments to agents who they have reason to know will make such bribes, in order to assist the corporation in getting or retaining business for or with any person.[28] The definition of foreign official does *not* include any foreign government employee whose duties are essentially ministerial or clerical. Thus, so-called grease money payments such as those made to customs officials in many countries are not made illegal by this act.

[26] See SEC, Report on Questionable and Illegal Corporate Payments and Practices (Comm. Print 1976) (submitted to the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess.); Business Without Bribes, Newsweek, Feb. 19, 1979, at 63; Note, Effective Enforcement of the Foreign Corrupt Practices Act, 32 Stan. L. Rev. 561 (1980).

[27] 15 U.S.C. §§78a, 78m(b)(2)-78m(b)(3), 78dd-1, 78dd-2, 78ff.

[28] 15 U.S.C.A. §§78dd-1, 78dd-2.

Exchange Act §13(b)(2)

Because in many of the reported bribery cases various directors and top officers claimed not to have known what was going on, Congress also added an accounting controls provision. This provision, which became Section 13(b)(2) of the Securities Exchange Act, applies to all corporations having securities registered under the Act, or having to file reports under it, that is, to most public corporations in the United States. Such corporations have to make and keep books, records, and accounts that, in reasonable detail, fairly and accurately reflect their transactions and the dispositions of their assets. They must also "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that four conditions are met:

(1) Transactions are executed in accordance with management's general or specific authorization.
(2) Transactions are recorded as necessary (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (b) to maintain accountability for assets.
(3) Access to assets is permitted only in accordance with management's general or specific authorization.
(4) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Potential impact

Two comments must be made about Section 13(b)(2). First, as a formal matter, its potential impact on corporations is great. Despite its genesis, the provision applies to virtually all public corporations, not just those engaging in foreign trade. It applies to accounting controls with respect to all kinds of corporate transactions and uses of assets; it is not at all restricted to controls that might uncover foreign bribes. Because of its generality and its apparently formless wording, corporate managers and attorneys later began to fear that the SEC, by virtue of its ability to make rules spelling out and implementing the provision, would use it to embark on a sweeping program of mandated reforms of corporations' internal communication and control systems. Thus far, however, the SEC has done little to substantiate these fears.

Aids to interpretation

Second, the list of four conditions that a system of internal accounting controls is supposed to assure was taken almost verbatim from Statement of Auditing Standards Number One of the American Institute of Certified Public Accountants, the chief trade association of the nation's independent

certified public accountants, who do the work of auditing corporations' financial statements. There is a considerable lore on what auditors do or should do that may therefore be availed of by the SEC or the courts in their efforts to give meaning to Section 13(b)(2). Textbooks on auditing procedures,[29] for example, identify numerous specific tasks that an auditing firm must carry out in fulfillment of its duty to evaluate the audited company's system of accounting controls. What good accounting firms actually do, and which specific tasks are considered most important in the profession, can be explored via expert testimony of qualified accountants.[30]

Significance of state/federal contrast

The contrast between state law and the federal statute is instructive. It illustrates the tendency of state courts to fail to adopt rules that are suitable for the governance of large public corporations. Leaving corporate managers the discretion to decide whether to adopt a triggering event approach or a systemic approach to internal monitoring is a policy choice that makes eminent sense if the rule one adopts is going to govern the affairs of many close corporations. This is so because in a close corporation, where the small number of key participants and their greater incentive makes informal monitoring and cross-checking more feasible, the cost of adopting a formal system of internal accounting controls could be far out of proportion to any expected benefits. There are economies of scale that apply to the benefits that may be expected to flow from a formal, rule-governed system

[29] E.g., Burton, Palmer, & Kay, eds., Handbook of Accounting and Auditing chs. 9-16 (1981 & supp.). For an overview of auditing, see S. Siegel & D. Siegel, Accounting and Financial Disclosure 129-143 (1983).

[30] Of course, it is the courts that must finally declare the meaning of the law. They may decide for themselves that any particular auditing procedure was or was not called for by the statute in the circumstances of a given case, and they might decide that certain generally followed auditing procedures (as opposed to the more abstractly formulated generally accepted auditing *standards*) are simply too lax to constitute compliance with the statute. Moreover, even if a court or the SEC wants to give great deference to received standards within the auditing community, it may find itself with important unanswered questions. It is said by some experts, for example, that various factors "contribute" to effective internal control, such as competent personnel, a clear-cut organizational structure, a well-designed accounting system, limited access to assets by unauthorized persons, and the existence of an effective internal auditing staff. Suppose a large corporation has no separate internal auditing staff: Should that by itself mean that it has violated §13(b)(2)?

Or consider that Statement of Auditing Standards Number One distinguishes between accounting controls and administrative controls. It defines administrative controls to include "the plan of organization and the procedures and records that are concerned with the *decision processes* leading to management's authorization of transactions." As a matter of statutory interpretation, should the SEC and the courts follow this or a similar distinction in implementing §13(b)(2) and therefore limit the potential range of the provision by not embracing within it anything that should properly be classified as an administrative control? Certainly a strong case could be made that the statute does not authorize the SEC to require corporations to set up *general legal* compliance programs or legal audit programs.

of controls. On the other hand, that a large public corporation with thousands of employees could decide to do without internal auditors is a possibility that ought to be discouraged or ruled out of existence.

§3.5 *The Limits of the Business Judgment Rule*

In subsection 3.4.1, we saw how directors may be held liable for negligence, or gross negligence, despite the business judgment rule. The application of the business judgment rule to two special phenomena that have generated great controversy, derivative lawsuits and defensive maneuvers to takeover bids, will be dealt with later (in sections 15.2 and 13.6.2, respectively). In this section I focus on some rather different, general aspects of the rule's limits.

Four kinds of challenge to decision of directors

Judicial deference to directors' business judgment might mean not only that courts will not closely scrutinize directors' carefulness, but also that they will not weigh the directors' decisions against competing goals and policies. Is this what in fact happens? It is to this question that we now turn. We have already given a statement of the business judgment rule. Let us consider, in order, cases in which a business judgment conflicts or competes with

(1) another business judgment,
(2) a social or personal goal of the managers,
(3) the managers' self interest, and
(4) specific legal rules and policies.

(1) Decision was wrong

As an example of the first conflict, the directors and officers of a corporation owning a baseball team may honestly think that restricting games to those held in the daytime is in the shareholders' best interest, whereas some shareholders, armed with statistics about what other teams do, may earnestly believe that night games are the key to adequate profits. In this situation a court would simply not permit a shareholder challenge to the managers' judgment to go forward, even if it suspected or believed that the shareholders' business arguments would be much more persuasive than those of the managers. This is a primary or paradigmatic application of the business judgment rule.

(2) Decision aimed at social goal, not profits

But let us change the facts to create the second kind of conflict. Suppose, as happened in *Shlensky v. Wrigley*,[1] the shareholders' complaint included

§3.5 [1]237 N.E.2d 776 (Ill. App. 1968).

the charge that Wrigley, the president and 80 percent shareholder of the corporation owning the Chicago Cubs, refused to install lights at Wrigley Field and thus make night games there possible, not because of his interest in the corporation's welfare but because of his personal convictions that daytime games were better for the neighborhood around Wrigley Field and that they fit the concept of baseball better. The court, while appearing to concede that directors ought not to act for reasons unrelated to the corporation's financial interest, nevertheless affirmed dismissal of the plaintiffs' complaint. It said it was "not satisfied that the motives assigned to [Wrigley and the other directors] are contrary to the best interests of the corporation and the stockholders."[2] It sketched a scenario in which concern for the neighborhood would be in the corporation's long-run interest but then quickly denied it was deciding that the directors' decision had been a correct one in fact. "We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision."[3]

Ambiguity of *Wrigley* case

The *Wrigley* case seems to stand for the proposition that the business judgment rule precludes a shareholder attack on the directors' business decisions on the grounds that the decisions were actually motivated by the directors' perception of social values. But the court seemed reluctant to hold outright that corporate managers are perfectly free to use corporate assets to implement their vision of the social good, at the expense of the shareholders. After all, the shareholders contributed the capital, own the residual claim on the assets, and may have a very different vision of the social good. The *Wrigley* holding is therefore puzzling.

Possible reasons for limiting challenges

The case may be construed as a decision based on considerations of appropriate judicial process. The point would be that courts should usually prohibit shareholders from attempting to prove management's real motivations in this kind of case. The reasons for this prohibition might be several.

First, real motivations are very difficult to prove.

Second, allowing shareholder to challenge directors' decisions on the basis of real motivations will simply tempt management to perjury at the time of trial. They will say, always with some plausibility, that they actually thought that a given decision was in the corporation's long-run interest.

Third, well-advised managers will easily forestall all such challenges by couching all documentation about corporate decisions in vague rhetoric

[2]Id. at 780.
[3]Ibid.

about the corporation's long-run interest. (So why discriminate against managers with less sophisticated legal advice?)

Fourth, managers' decisions to further their social values at the shareholders' expense are in fact rare and systemically unimportant. When such decisions do occur, their purpose may be publicly and clearly announced,[4] in which event a court heartened by the clear absence of difficult problems of proof might indeed allow a shareholder challenge.

(3) Decision was tainted by self-interest

A third conflict involves competition between business policies and managerial self interest. Suppose that the directors and officers of Toy Corporation cause it to buy a ton of expandrium, a new multipurpose raw material, from the Nightflyer Company for $1 million. Shareholder Small brings a derivative suit against all the directors and officers, claiming that they had a substantial personal financial interest in Nightflyer and that the purchase was unfair to Toy Corporation. This suit would *not* be dismissed because of the business judgment rule, because the rule does not apply to such a cause of action. This is an important point to grasp, for the vast body of case law on conflicts of interest and self-dealing that is discussed in subsequent chapters depends on it. The charge is not simply that the managers' business judgment was wrong, but that it was corrupt. In a sense, the plaintiff is arguing that the managers' decision was not a *business* judgment at all but a self-interested *personal* judgment. In contrast to the *Wrigley* court's attitude toward the social values allegedly motivating managers, the courts have shown little reluctance about letting shareholders try to prove that managers were really motivated by selfish personal goals. Perhaps the difference lies in the courts' perceptions that the selfish brand of ulterior motivation is much more frequent and serious.

Caveat

An important caveat to the preceding paragraph is that, if not all of the Nightflyer directors were personally interested in the expandrium sale, the defendant directors and officers might be able to get back under the business judgment rule by invoking the informed approval of the deal by the disinterested directors. (This important possibility is considered at various points in subsequent chapters.) They might even benefit by the recommendation to a court by the disinterested directors that a derivative suit against them be dismissed (see subsection 15.2.3).

(4) Decision was illegal: example of *AT & T* case

Finally, consider conflict between business goals and legal policies. In *Miller v. American Telephone & Telegraph Co.*,[5] the stockholders brought a

[4]See, e.g., Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

[5]507 F.2d 759 (3d Cir. 1974), on remand, 394 F. Supp. 58 (E.D. Pa. 1975), aff'd without op., 530 F.2d 964 (3d Cir. 1976).

suit against AT & T's directors on account of the company's failure to collect an outstanding debt of $1.5 million owed it by the Democratic National Committee for communication services provided during the 1968 Democratic National Convention. The plaintiffs claimed not only that the directors negligently failed to pursue a valid corporate claim, but also that the failure amounted to AT & T's making a contribution to the committee in violation of a federal law about corporate campaign spending. The Third Circuit reversed a dismissal of the complaint, holding that the business judgment rule could not insulate the directors from liability if they did in fact violate the federal statute. It based its result both on the underlying purposes of the federal statute, which included destruction of corporate influence over elections *and* checking the practice of using corporate funds to benefit political parties without the stockholders' consent, and on the New York law regarding illegal acts. (AT & T was a New York corporation.) Under that state's decisions, illegal acts may amount to a breach of fiduciary duty by the directors and officers even when committed to benefit the corporation, because directors should be restrained from engaging in activities that are against public policy.[6] These holdings go beyond the platitude that courts will not hold that directors' violations of criminal statutes are proper if done for a corporate purpose, because they add the private enforcement activities of interested shareholders to the efforts of public prosecutors and regulators.

"Hands off" the key concept?

Perhaps the main impression arising out of the duty of care and business judgment cases is that under these notions courts place fairly limited restraints on private decision making. *Allis-Chalmers* suggests that courts are loath to *require* directors to design a monitoring system to enforce non–profit-maximizing legal policies, in the absence of a legislative judgment to that effect; but *Wrigley* suggests that in practice courts will *allow* directors to temper business decision making with their perceptions of social values; and the *AT & T* case suggests that they will *allow* shareholders to use the derivative suit mechanism to enforce general legal policies, not just to protect the financial welfare of the corporation. Therefore, although the official purpose of the business corporation may be to maximize profits, legal doctrine may leave managers and shareholders leeway to grind other axes. It is important not to overstate this point, of course. We have discussed only a few cases, and they may not predict well what most state courts would do in similar situations. (In particular, note that *Wrigley* is a

[6]See Abrams v. Allen, 74 N.E.2d 305 (N.Y. 1947), reh. denied, 75 N.E.2d 274 (N.Y. 1947); Roth v. Robertson, 118 N.Y.S. 351 (Sup. Ct. 1909).

decision of one lower court in one state; and similar holdings elsewhere appear nonexistent.)

In any event, there is one major, indeed all-important, class of cases that falls outside the protection of the business judgment rule: those involving managerial fraud and self-dealing. It is to this vast body of legal material that we now must turn.

CHAPTER 4

INTRODUCTION TO CONFLICTS OF INTEREST

§4.1 *The Conflict-of-Interest Paradigms*

Fiduciary duty of loyalty

Directors, officers, and, in some situations, controlling shareholders owe their corporations, and sometimes other shareholders and investors, a fiduciary duty of loyalty. This duty prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions. They may not abuse the beneficiaries in situations in which they have a conflict of interest. In some contexts, they may act improperly simply by maintaining a state of affairs in which they have a conflict of interest. Most importantly, this general fiduciary duty of loyalty is a residual concept that can include factual situations that no one has foreseen and categorized. The general duty permits, and in fact has led to, a continuous evolution in corporate law.[1] At the same time, the courts and legislatures have developed more specific rules, or particular fiduciary duties, to deal with many recurring situations involving a conflict of interest.

Four paradigms

I find it useful to group the recurring situations into four clusters. Each cluster implicates somewhat different dangers and calls for a somewhat different legal response. In this section I will introduce each cluster by a

§4.1 [1]For efforts to identify and analyze the elements of the fiduciary duty of loyalty in a general way, see Clark, Agency Costs Versus Fiduciary Duties, in Principals and Agents: The Structure of Business 55, 71-79 (J. Pratt & R. Zeckhauser eds. 1985); Frankel, Fiduciary Law, 71 Calif. L. Rev. 795 (1983).