FIDUCIARY STANDARDS APPLICABLE TO OFFICERS AND DIRECTORS AND THE BUSINESS JUDGMENT RULE UNDER DELAWARE LAW

BY RODMAN WARD, JR.*

CHANCELLOR QUILLEN: We start this morning with fiduciary standards. You heard yesterday from Rod Ward, and he will lead off on that topic this morning.

MR. WARD: Three of us are going to discuss this mandatory topic for any discussion of corporation law. Officially, the lecture on fiduciary duty will now begin. I'm going to talk about it in a rather general Delaware context. Dick Corroon will discuss the area that, so far as the law of Delaware is concerned, he has largely created with the assistance of the judiciary — that is, intercorporate transactions of self-dealing in parent subsidiaries. Norm Veasey is going to discuss comparison with the Model Business Code.

The classic statement recently of fiduciary duty referred to in *Singer v. Magnavox,*[1] in that case in the context of a majority stockholder but nonetheless drawn from the duty of a director, is from the equally classic case of *Guth v. Loft,*[2] a Delaware case that has been cited in nearly every jurisdiction that's considered this question. Fiduciary duty is public policy, it's a duty owed to the corporation and to its stockholders. A director must protect the interests of the corporation committed to its charge and must refrain from doing anything that works injury to the corporation, to deprive it of profit, to deprive it of advantage which he might bring to it or enable it to make. His loyalty shall be undivided and unselfish, and there shall be no conflict between duty and self-interest. Really, the rest of it is a refinement of those general standards.

Nowhere, however, and certainly not in the view of our courts, are directors required to be superhuman or beyond mistake or insurers of damages which their companies may suffer. So long as they do what they believe to be in the best interest of the corporation and in their best judgment, the directors and officers are protected from liability to the corporation and its stockholders. This so-called business judgment rule, at least in my view, is an application of

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1. Singer v. Magnavox Co., No. 289, 1976 (Del. Sept. 23, 1977, revised Nov. 2, 1977).

2. Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

practical reason to corporate affairs. It is not practical for a court, and our courts have said essentially this, to rethink a business decision. The prospect of such second guessing would cause a kind of caution and self-protection in the board room which would be counterproductive to the efficiency of business. An excellent formulation of the business judgment rule was found in Nathan and Shapiro, *Legal Standards of Fairness of Merger Terms Under Delaware Law,* which is found in *The Delaware Journal of Corporate Law.*[3] That's not in the outline nor in the supplementary bibliography which was prepared by the Delaware Law School students, but I think it's a very fine article. Chuck Nathan who wrote it is one of the ablest corporate lawyers in the country, and he had excellent assistance from K. Shapiro. Board actions, they said, are presumed reasonable and a plaintiff must bear a heavy burden of showing lack of any business purpose amounting to actual or constructive fraud before a court will interfere with the decisions reached by the board. Of course, where a transaction involves self-dealing or similar conflicts of interest, the business judgment rule does not apply. The presumption disappears and the proponents of the action must prove the intrinsic or, as we now are saying, the entire fairness of the arrangement. I think Nathan and Shapiro in footnote 5 on page 46 of their article make a very perceptive point when they tie these two things together and write as follows:

> The legal standards of the "business judgment" rule and the "intrinsic [or entire] fairness" test might be viewed as two extremes on a continuum. The Delaware courts have formulated some intermediate positions. Thus, for example, if a transaction is done in haste, a court may scrutinize the terms clearly even though granting some weight to business judgment.

For that proposition, they cited Chancellor Quillen's opinion in *Gimbel v. Signal Cos.*[4] where there's something less than the disappearance of the business judgment presumption or rule, but the court felt that because that transaction was done hastily, more scrutiny should be given to the terms of the transaction.

Similarly, they said "there may be judicial scrutiny if directors 'can be said to have passed an unintelligent and unadvised judgment.' "[5] For that proposition, they cited *Mitchell v. Highland*

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3. 2 DEL. J. CORP. L. 44 (1977).
4. 316 A.2d 619 (Del. 1974).
5. 2 DEL. J. CORP. L. at 46 n.5 (quoting Mitchell v. Highland-Western Glass Co., 19 Del. Ch. 326, 330, 167 A. 831, 833 (Ch. 1933)).

Western Glass.[6] I would add *Kaplan v. Centex,*[7] which holds that business judgment must have been brought to bear with specificity on a transaction if it is to serve as a valid defense.

While we are talking about directors bringing judgment to bear on transactions, I suppose it would not be out of place to refer to the scope or breadth of the transactions on which the director's judgment should be brought to bear. Norm [Veasey] will be talking about this in the context of the Model Business Act, but I have never fully understood the criticism that *Graham v. Allis-Chalmers*[8] has received from scholars and, in the case of Professor Cary,[9] scholar practitioners. In that case, you will recall the court held that directors might rely on summaries, reports and corporate records as evidence that no antitrust violations were being committed by the company even though nineteen years earlier the FTC had issued a cease and desist order against price fixing. I think if you start urging a contrary rule, you fall into the problem that there is bound to be some limit in the capacity of a director to know what is going on in his company. He can't see every sparrow that falls off the limb, or whatever that quotation is.[10] If, on the other hand, you say that, well, being once bitten, there ought to be some system to prevent this from happening, I think you almost fall into another and perhaps worse problem, which means that you are going to create some kind of inspector general system, which may or may not be more expensive than whatever lawsuits may occur to the corporation from the failure to have it.

It's a wonderful thing to stand back and say that any faults or errors should have been seen by a director in an enormous corporation like Allis-Chalmers, but it's hardly a practical thing. Whether a company is to set up a structure to ferret out problems of this sort, it seems to me, is more an economic decision of the company than it is an appropriate concern for the courts. Of course, as with any other statement of principle or general principle like that, I suppose it depends on the degree of warnings that such things

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6. Mitchell v. Highland-Western Glass Co., 19 Del. Ch. 326, 330, 167 A. 831, 833 (Ch. 1933).

7. Kaplan v. Centex Corp., 284 A.2d 119 (Del. Ch. 1971).

8. Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963).

9. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663, 683-84 (1974).

10. "Who sees with equal eye, as God of all,/A hero perish or a sparrow fall,/Atoms or systems into ruin hurl'd,/And now a bubble burst, and now a world." Alexander Pope, *An Essay on Man,* epistle I, *1.* 87 *in* J. BARTLETT, FAMILIAR QUOTATIONS: A COLLECTION OF PASSAGES, PHRASES, AND PROVERBS TRACED TO THEIR SOURCES IN ANCIENT AND MODERN LITERATURE, 408 (1968).

are likely to happen, and perhaps should be judged by the trial court faced with the circumstances at hand.

But it seems to me that *Graham v. Allis-Chalmers,* rather than being one of the weaker legs in our law, is one of the stronger and one of the more practical applications of reality to the management of corporations and the criticism can be seen as largely, or to a large degree, ivory tower. One is reminded of former Mr. Justice Goldberg's view that corporate directors should be provided with large staffs of experts — accountants, lawyers, perhaps in his case public relations advisors — and all of these people would troop around presumably behind Mr. Justice Goldberg if he went to the meetings of the board of directors, and sit behind him, much as the diplomatic staff sits behind somebody at an international conference, and if something comes up they would consult and he would speak. That's a very expensive thing, it seems to me, and I certainly hope we never come to that, or I certainly hope that no court ever requires us to come to that, although that is one of Mr. Nader's proposals to fix up the business community.[11]

Problems of self-dealing are dealt with in Delaware by statute. Section 144 of the Code sets the ground rules.[12] Section 144 authorizes transactions between directors and their corporations or interlocking corporations if the interest is disclosed, the disinterested directors approve, or the stockholders ratify or the transaction is fair. Here, I assume the burden is on the proponent of the transaction.

Moving to the spending of corporate funds — I think Dick Corroon is going to go into that in greater depth. Spending corporate funds by management for the preservation of control is another very timely topic. The Wall Street Journal, as you may recall, had an article[13] on lawsuits that arise or may arise from defense tactics by target companies defending against tender offers. That is a circumstance which, of course, is fraught with fact and since the defense tactics often bring in larger offers, possibly what is considered to be self-interest is simply on the part of management, and management may want to get a better deal from some other bride or some other and better deal for themselves. But quite frequently their self-interest, as you recognize, is consistent with the best interest of the stockholders. In the *Royal v. Monogram*[14]

11. *See, e.g.,* NADER, GREEN & SELIGMAN, TAMING THE GIANT CORPORATION (1976).

12. DEL. CODE ANN. tit. 8, § 144 (1974).

13. Wall St. J., July 15, 1977, at 1, col. 6.

14. Royal Indus., Inc. v. Monogram Indus., Inc., No. 76-3356-R (S.D. Cal. Oct. 27, 1976). Royal brought suit in federal district court alleging antitrust violations and

situation, the Royal directors waged an intensive battle which was highly criticized by Judge Manuel Real in the California federal court.[15] During that period of time, Judge Real leveled charges from the bench that vast amounts of corporate money were being spent for defense and indeed he made them go out and get a list of attorneys' fees that had been paid and bring it to the court so that he could examine the extraordinarily large amounts of money and chastise the Royal people. Royal was on the other side from us, and we were enthusiastic about that course of action that the judge was taking, but in the long run, one must be candid and say that the stockholders got more from Lear Siegler[16] than they were going to get from Monogram. If management spent a lot of money to preserve their positions or perhaps to get a better deal from Lear Siegler, it was consistent with the better deal the stockholders got in money at the end of the deal.[17]

The cases go different ways on their facts. All the cases that exist in Delaware on the subject — and there's a rich vein of cases here on that subject — are set out in our outline.[18] The burden, once again, is placed on the directors to justify their actions of spending this money, and to justify that those actions are consistent with their fiduciary duty. I think that the recent decision of the Delaware Supreme Court in *Lynch v. Vickers,*[19] which you all have, makes clear, at least to me, that directors have a fiduciary duty of complete candor with their stockholders. I don't believe anybody ever doubted that they had the duty of complete candor. I think those who were more familiar perhaps with securities litigation thought that the information that directors were obliged to furnish — full and complete, not misleading, no omissions, and all the rest — were more grounded in the law of misrepresentation or fraud. But the

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seeking an injunction to prevent a tender offer Monogram was making for 3,200,000 shares or 55% of the common stock of Royal for a cash payment of $11 per share. For the facts of the case, *see* Royal Indus., Inc. v. Monogram Indus., Inc., 366 A.2d 839, *rev'd* 372 A.2d 171 (Del. 1977) which involved an effort by Royal to restrain the tender offer in Delaware court.

15. *See Judge Restrains Effort by Royal Industries to Block Monogram,* Wall St. J., Dec. 9, 1976, at 27, col. 1.

16. Lear Siegler, Inc. made a tender offer for all Royal stock at $13.50 per share. *See Royal Industries Gets Higher Offer From New Suitor: Lear Siegler Planning to Bid $13.50 a Share, Topping Monogram's $11 a Share,* Wall St. J., Dec. 17, 1976, at 8, col. 2.

17. Lear Siegler ultimately prevailed with its tender offer which was recommended by the Royal board unanimously. *Id.; Lear Siegler Agrees to Settlement in Bid for Royal Industries,* Wall St. J., Dec. 24, 1976, at 2, col. 2.

18. See appendix E, this issue, p. 360 *infra.*

19. Lynch v. Vickers Energy Corp., No. 70, 1976 (Del. Oct. 18, 1977).

foundation in fiduciary duty is clear from the *Lynch* case where Justice Duffy says on page ten of the slip opinion,

> Given Harrell's[20] undisputed qualification and his status in management, we conclude that failure to disclose the substance of his report was a violation of the fiduciary duty owed by defendants to plaintiff. Without question, Harrell's estimate . . . was germane to the tender offer and included the type of information which a reasonable stockholder would consider important in deciding whether to sell or retain stock.

Then there's the "compare" cite to *TSC v. Northway*[21] which is a federal securities case; so apparently the base bottom of the obligation is the fiduciary obligation, but the standards of materiality are those of the Securities Act. That leaves open the question of whether a competitor for control, either in a proxy fight or in a tender offer, has a comparable duty under Delaware law to be equally candid. It can hardly be said that someone who is seeking to take over a company has a fiduciary duty, well, maybe it could, but I wouldn't think it would be properly said that he has a fiduciary duty, at least yet, and then the question is, does the management have a higher duty to tell the truth and the person who's coming in to take over the company has some lesser duty. I wouldn't think that the court would come out that way, but if it is going to come out differently they will have to go to a misrepresentation standard, it seems to me, for the outsider.

One of the points that is of interest in the question of controlled mergers is the effect of the approval of the majority of the minority after full disclosure. I assume that Dick Corroon is going to speak about that, so I guess I'll pass on to the next point. The corporate opportunity doctrine seeks to analyze the fiduciary duty of the director or an officer when faced with a business opportunity. We in Delaware are privileged to have the leading cases on corporate opportunity and the cases that are cited everywhere in the country for that proposition. The *Guth*[22] case, being the leading case. The rule is relatively simple. The opportunity belongs to the company and the director violates his fiduciary duty by taking it if the company can afford the opportunity, if it is in the company's line of business, and it will be practical, if it will be of practical advantage

20. Forrest Harrell, a petroleum engineer and a vice-president of Transocean, had prepared an estimate of the value of Transocean's assets. For a statement of the facts, see the opinion by the chancery court, 351 A.2d 570 (Del. Ch. 1976), *rev'd* No. 70, 1976 (Del. Oct. 18, 1977).

21. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

22. Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

to the company, or the opportunity is one in which the company has an expectant interest. On this subject, of course, the officers and directors have the burden of proof — the fellow who is said to have taken the opportunity. Even our great company here, the Du Pont Company, once had a corporate opportunity case which was resolved by a vote of the stockholders, and I say happily resolved.[23]

Lastly, a corporation's confidential information belongs to the company. It is its property, just like any other property. The fiduciary is seen as a person taking care of assets. He has to tell the truth about them, he has to handle them with care, he has not to take them, and if he has any confidential information about them he can't profit by it because that information belongs to the company. Long before *Diamond v. Oreamuno*[24] in the court of appeals of New York, the chancellor in *Brophy v. Cities Service*[25] held that an insider who profits by the use of inside information holds his profits as constructive trustee for the corporation. That rule, when adopted by the New York court, was heralded as a magnificent advance in the law, an advancement which Delaware had made I think about twenty years before. Interestingly enough, later on when Florida was given the opportunity to adopt a rule, they declined to,[26] so it's not exactly the rule everywhere. That concludes my remarks. I would refer you, however to the outline which is published here.[27] It has a great number of Delaware citations and excerpts from cases and is organized essentially as the same structure as my remarks were. Thank you.

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23. Du Pont v. Du Pont, 242 F. 98 (D. Del. 1917).

24. Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (N.Y. 1969).

25. Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5 (Ch. 1949).

26. *See* Schein v. Chasen, 313 So. 2d 739 (Fla. 1975).

27. See appendix E, this issue, p. 360 *infra.*

FIDUCIARY STANDARDS APPLICABLE TO OFFICERS AND DIRECTORS AND THE BUSINESS JUDGMENT RULE UNDER DELAWARE LAW

BY RICHARD F. CORROON*

MR. CORROON: Despite the promises that Rod Ward has made, I'm going to address myself to one very narrow issue. It involves the mergers of parents and partly owned subsidiaries, and my specific question is whether an individual who serves on the board of the parent and also on the board of the partly owned subsidiaries has the same duty to both or whether his duty to the parent is greater than his duty to the partly owned subsidiary. I'm going to discuss only three cases: *Greene v. Dunhill,*[1] *Getty v. Skelly,*[2] and *Levien v. Sinclair.*[3] Before I start, I should make sure that you all know that I have an in-built bias because I represented the plaintiff in both *Green v. Dunhill* and *Levien v. Sinclair,* and two of my partners represented Getty in the third case that I will discuss.

In the *Greene* case, Dunhill owned 80% of the shares of A. G. Spaulding Company, and they announced a proposed merger of the two companies. David J. Greene Company, the plaintiff, filed a motion for preliminary injunction which was granted by then Chancellor Duffy. The case was not appealed and was settled before trial. But the Chancellor said in his well thought-out opinion:

> When a Delaware court is called upon to determine whether a proposed merger between a parent corporation and a subsidiary which it controls (and which has minority stockholders) should be enjoined, fairness is the established criterion for judgment. [He does not say the business judgment rule is the criterion.] That is the litmus test to which the transaction must be submitted.
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> . . . But when the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present. Intrinsic fairness, tested by all relevant standards, is then the criterion.

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1. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427 (Del. Ch. 1968).

2. Getty Oil Co. v. Skelly Oil Co., 255 A.2d 717 (Del. Ch. 1969), *rev'd,* 267 A.2d 883 (Del. 1970).

3. Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1969), *rev'd in part,* 280 A.2d 717 (Del. 1971).