ACCOUNTABILITY OF OFFICERS AND DIRECTORS

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MR. MAXWELL: In my outline I did with the stroke of a pen that which is not, in reality, very easy to do, and that is, namely, I have decided to consider the director's duty of care in the management of the company separate from the duty of loyalty to the corporation. The two very often are on opposite sides of the same question and not very easy to separate. For example, in the typical take-over litigation where the target company has taken certain defensive measures (which I heard on Tuesday in court described as shark repellant), the directors say that they took these measures in their best business judgment, and the other side, of course, argues that there was no proper business purpose and that the directors acted selfishly and in their own interests in order to keep their jobs.

But I think it’s necessary here actually to separate the two so that we don’t become confused any way in the terminology. The director’s duty of loyalty, which is a real and separate duty from the duty of care in the management of a corporation, is probably more akin to areas in the trust law which is applied by analogy to corporate directors. But here, and in my outline, I have focused upon the director’s duty of care in the management of the company.

This is somewhat of a topical nature because there has been a great fever in recent years to adopt statutory standards of conduct. One of the better known is the effort of the committee which oversees the Model Business Corporation Act to incorporate a statutory standard of care.1 In my outline I have quoted that portion of the amendment 2 that I would be concentrating on in connection with the overview in the area of accountability that I am presenting this afternoon.

I understand that Norman Veasey earlier in this seminar has concentrated on this topic of the ABA standard, and I won’t go into it in a great deal, but I understand that he devoted a presentation yesterday to section 35 of the Model Act.3 Incidentally, I am going to refer a little bit to the Business Judgment Rule in Delaware, and I speak to you with a great deal of innocence and therefore confidence, I suppose,


3. Id.
because I do not have the benefit of reading the outlines of Mr. Veasey and Mr. Arsh who did get into more detail in the two areas I am talking about. So I don't know where they disagree with me, so I can speak to you with a great deal of confidence that what I am telling you is right.

The Model Business Corporation Act in Section 35 apparently adopts a reasonable man standard, and there is one word that I would like to pull out and to emphasize, and that is the word "reasonably." The Model Act, as you may know, provides that "a director shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." 4

I pull out that word because there has been some question raised among some Delaware lawyers as to whether or not the insertion of that word in the Model Business Corporation Act offends in some way the traditional concepts of the Business Judgment Rule in Delaware. Obviously, the word "reasonably" connotes somewhat of an objective standard, and in the committee's deliberations, I should say the sub-committee's deliberations, here in Delaware on whether to adopt an analogue to section 35, there was some concern over adopting the language of the Model Act verbatim for fear that it might in some way do an injustice to the Delaware Business Judgment Rule.

In any event, one of the other relatively recent enactments has been in New York. 5 I think it is interesting,—I quoted the portion on page 2 of my outline which is the statutory provision in New York,—but it is interesting to note that New York leaves out entirely that particular part of the Model Act with which I can see some trouble. The New York statute provides that a director shall perform his duties "in good faith and with that degree of care which an ordinarily prudent person in like position would use under similar circumstances." 6

For a time, Delaware was caught up in this fever for some sort of statutory incorporation of the standard of care. A committee was appointed as a sub-committee of the Corporation Law Committee of the Delaware Bar Association, and for several years the committee members met and tried to decide whether they should adopt an analogue to section 35 of the MBCA here in Delaware. The sub-committee, as recently as last December, I believe, developed a unanimity of view that it would not recommend any such provision in Delaware. I think

4. Id.
6. Id. § 717 (McKinney 1977).
it is interesting, in the report to the Corporation Law Committee, the
chairman of that committee in the last paragraph of the report, states
as follows: "The more fundamental question remains, the need for
codification at all. Although I cannot record that all of the members
were of the same mind on the subject, I do think it is fair to say that
there was no strong pro-codification sense emerging from our study." 7
So it appears, at least at this time that, in Delaware, there will be no
recommended statutory codification of the standard of care.

That being the case, the question becomes, what is the standard
of care? Most of this standard, of course, is in Delaware developed
by the common law.

Recently in a New York Law Journal seminar on corporate
governance, a California lawyer—you may have seen a report of that—
was asked whether an individual board member would be protected
against violation of the SEC Proxy Rule 8 if he relied on what he was
told at a committee meeting without going over the material himself.
In an effort to be definitive in an area of uncertainty, in answer he said,
"an unqualified maybe." You may feel somewhat the same about me
when we start to look at the Delaware cases on the standard of care
because they're not, frankly, all that clear.

The case that is probably cited most often for stating the standard
of care in Delaware is Graham v. Allis-Chalmers Manufacturing Co. 9
It is true that that decision does contain some language which would
support the ordinary care approach that is usually attributed to Dela-
ware. In that case the court said, "Directors of a corporation in
managing corporate affairs, are bound to use that amount of care
which ordinarily careful and prudent men would use in similar cir-
cumstances." 10

Now, that sounds very good. Unfortunately, the court went on
to say, "In the last analysis the question of whether a corporate director
has become liable for losses to the corporation through neglect of duty
is determined by the circumstances. If he has recklessly reposed con-
fidence in an obviously untrustworthy employee, has refused or
neglected cavalierly to perform his duty as a director, or has ignored
either willfully or through inattention obvious danger signs of em-
ployee wrongdoing, the law will cast the burden of liability on him." 11

7. Report of the Committee on Corporation Laws: Changes in the Model
Business Corporation Act (unpublished portion of report available with the Com-
mittee on Corporation Laws).
10. Id. at 83, 188 A.2d at 130.
11. Id. (emphasis added).
So really, in the Allis-Chalmers case you find support, I suppose, for the notion that the Delaware law does tend toward an idea or a concept of gross negligence. However, both *Fletcher Cyclopedia Corporations* \(^\text{12}\) and an Annotation \(^\text{13}\) on this subject put Delaware in the ordinary care column, but of course, both of those authorities rely on the Allis-Chalmers case for that conclusion.

Also, there is the case of *Lutz v. Boas*,\(^\text{14}\) which appears to adopt the straight, or ordinary negligence standard, but unfortunately, again in the opinion, the court actually finds that the directors were "grossly negligent." \(^\text{15}\)

My own view is that the test of ordinary care set forth in the Allis-Chalmers case is probably correct because it seems to me not to be too convincing to suggest that the directors of the Delaware Corporation are only liable for gross negligence. I don't know of any attorneys who seriously advocate that gross negligence is the standard of the Delaware Common Law. But an argument to that effect would at least pass the blush test since the language in some of the cases does support that argument.

Also, the case of *Penn Mart Realty Co. v. Becker*,\(^\text{16}\) is often cited in this area. Again, it's not very helpful. The court said, "Fraud and self-dealing are not the only ways in which corporate directors may breach their fiduciary duty; they may also breach that duty by being grossly negligent or by wasting corporate assets." \(^\text{17}\) Again, the court unhelpfully uses the term "gross negligence", but there I think the reason may be the problem of the pleadings in that case rather than the court, because what was pleaded in that complaint was gross negligence and waste of corporate assets. So the court simply may have been using the language that the plaintiff came up with.

Even though it can be said that the basic standard of care in Delaware has not been carved on stone, I think it is fair to say that the Business Judgment Rule is—in fact I have heard it described recently as—the core precept of Delaware law in this area.

Mr. Arsh has, according to the schedule, given you a full presentation on the Business Judgment Rule. Again, with all innocence I put forth in my outline my own statement of what I think the rule is, and I think it is this: In the absence of fraud, self-dealing, bad faith, gross abuse of discretion or other misconduct, or other situations ex-

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12. 3 *Fletcher, Cyclopedia Corporations* § 1037 (1975).
15. *Id.* at 609, 171 A.2d at 395-96.
17. *Id.* at 351.
pressly provided for by statute, the business decisions made by the board of directors in good faith, in the exercise of their best judgment and for what they believe to be the advantage of the corporation and all its stockholders, will not be reviewed by the court.

I have chosen to include in my definition some language from the Allis-Chalmers and General Gas & Electric Corp. cases. I could have chosen language from any of several cases, but it seemed to me that those are pretty well accepted by the courts, and I think it's a fair expression of the Business Judgment Rule.

There are several aspects of the Business Judgment Rule that, I think, are interesting and that you should be aware of. In the first place, the rule does assume, of course, that a director has acted. In a relatively recent case, however, as I put in my outline, it shows that a director may act by acquiescence. That's the case of Ella M. Kelly & Wyndham, Inc. v. Bell.18

Secondly, although there is no reported decision directly on point, the rule, as set out in Bodell, the Business Judgment Rule, I conclude, is probably subjective in that the actual belief of the directors is important, rather than an objective standard such as one might argue is now incorporated in the Model Business Corporation Act, i.e., the standard of reasonable belief.

However, again in this area, the courts have not been entirely helpful because I have noted two cases which imply, in my judgment, some objective overtones in the application of the Business Judgment Rule. One is Cheff v. Mathes,19 where the court found that the board believed "with justification" that there was a threat to its continued existence, and also in Muschel v. Western Union Corp.,20 where the court found that the board had made an informed judgment "which can be attributed to a rational business purpose."

Also, the application of the Business Judgment Rule does depend upon the informed judgment of the board, and the exercise of business judgment means an informed judgment. I know that Justice Quillen would agree with that because he's the one who said it in Gimbel v. Signal Cos.21

Also, there are in this area some attorneys who talk about reliance, good faith reliance, and in some of the situations the courts have, under the common law, found justification in the board's reliance on various experts. I think, however, that what the courts are really

doing is talking about informed judgment, so I have listed under the 
Business Judgment Rule the cases where the courts have held that 
certain directors have justifiably relied on certain experts where they 
could not take advantage of section 141 of the Delaware General 
Corporation Law. I think the courts really are talking about whether 
the directors have exercised their informed judgment.

Also, I have included in my outline, and I won't go over them, 
several situations and examples of the application of the Business 
Judgment Rule. It should be noted also that the rule does act as an 
evidentiary, rebuttable presumption in favor of the director.

Now the question becomes, are all directors held to this same 
standard (having definitively set forth what that standard is)? Some 
persons suggest that there is a compensation factor which does, or 
ought to, vary the standard of care to which a director is held. Under 
Delaware law it is permissible to compensate a director. As a matter 
of fact, the Delaware Law expressly gives that power to the board of 
directors to fix their own compensation.22

It probably is a good idea to pay the director something, and also 
to pay him continuously and regularly. The reason is that some of 
you may have seen recently that the Internal Revenue Service has 
ruled in a private letter ruling, Letter Ruling 7802005, which, inci-
dently, is not to be used or cited as precedent, whatever that means, 
that a corporate director who serves without compensation is not en-
gaged in a trade or business and so cannot deduct legal expenses that 
he incurs in defending a stockholder's derivative suit. The ruling says 
that a director who accepts a position as a director out of friendship or 
for personal or professional reasons, is not engaging in a trade or 
business. So it's probably a good idea to pay them, and the letter 
ruling does apparently use the words "continuously and regularly."

With respect to compensation as a factor, here please distinguish 
between a situation where compensation is a circumstance and where 
compensation is actually used in order to vary the standard of care. 
What I am talking about is a situation where a person is uncompen-
sated and so should have a different standard of care as a director 
from those who are paid.

The cases are all over the place. In this area, there are no Dela-
wre cases. There are cases in other jurisdictions, and you really can 
take your choice. I have categorized them in two areas: one, financial 
corporations; and two, other corporations. But I think probably the 
only definite thing that I can say is that all of these cases that I could 
find anywhere on compensation were decided between 1888 and 1925.

Therefore, I think we all can conclude that at least in other jurisdictions, this is not exactly a hot issue. . .

If I were to predict, humbly, what the attitude would be of the Delaware courts if they were faced with this question, I think that the correct view of the law is that the standard of care for all directors is or should be the same, but that the standard of care does take into account one’s own circumstances, and where compensation happens to be a relevant consideration in those particular circumstances, the court will consider it. If it is not relevant, the court will not, but that’s my own view.

Secondly, should it make a difference, or does it make a difference, as to whether or not a director is an outside or an inside director? I have set forth the policy considerations in my outline, but we won’t go over them except to say that some people say that outside directors ought to be encouraged to serve, so that we ought to lower the standard of care because they have less time to devote to the business, and we ought to encourage them to do so by lowering the standards.

Other people, notably Professor Cary, query whether the standard of care ought to be raised, or higher, for inside directors because they, in opposite fashion, have more time to devote to the business and also have better access to information.

There is no reported Delaware decision directly on point. Although I think it is interesting conceptually to argue the relative merits of these policy considerations, I submit that it’s difficult to formulate different standards of care for directors based on whether he is an inside director or an outside director because the categories, you will find as a practical matter, are not very easily applied. For example, Mr. Handelman, this afternoon, talked about the attorney who is serving on the board. Also, we all know that there are financial experts who serve on boards, and although they may be outside directors, they do have a certain element of expertise: and where you are talking about the possible liabilities in certain areas of expertise, then, it’s difficult to categorize people in one way or the other.

I think the answer here is that as set forth in Lutz v. Boas.\textsuperscript{23} I think that Delaware would not consider that an outside director ought to have a different standard of care than an inside director. But again, the standard of care is something that takes into consideration one’s own circumstances, and, again, where that happens to be a relevant factor, I think that the Delaware courts would consider it.

Incidentally, although I haven’t placed this as a separate category in my outline, you might be interested to know that apparently sex is

not a reasonable ground for diminishing the standard of care. The case here is *Francis v. United Jersey Bank* 24 which was just reported on December 8th of last year. What happened in this case was that there was a lady by the name of Pritchard who served on the board with her husband in a closely held corporation. I think it was an insurance company in New Jersey. Her husband died, and while she was running the business, and before her own death, apparently her sons took about $10 million from the business. I guess the estate of the mother was the one liquid asset around, so the other shareholders tried to get at the mother's estate.

The mother, or the representative of the mother, tried to defend on the basis that the mother was just a poor housewife and she ought not to be held to the standard of care that would hold her liable for the defalcation of her two sons. The court said,

> It has been urged in this case that Mrs. Pritchard should not be held responsible for what happened while she was a director of Pritchard and Baird because she was a simple housewife who served as a director as an accommodation to her husband and sons. Let me start by saying that I reject the sexism which is unintended, but which is implicit in such argument. There is no reason why an average housewife could not adequately discharge the responsibilities of a director of a corporation such as Pritchard and Baird despite the lack of a business career and experience, if she gives some reasonable attention to what she was supposed to be doing. The problem is not that Mrs. Pritchard was a simple housewife. The problem is that she took a job which necessarily entailed certain responsibilities and she then failed to make any effort whatsoever to discharge those responsibilities. The ultimate insult to the fundamental dignity and equality of women would be to treat a grown woman as though she were a child and not responsible for her acts of omission. 25

I have set out in the outline also, some statutory provisions which you have to talk about, or at least note because we are not going to talk about them very long, in connection with the discussion of the standard of care and accountability of directors because there are some statutory provisions in Delaware which do affect that standard of conduct.

I have grouped them into three categories, and I'm not sure I'm entirely satisfied with the categories I have grouped them into. I had to put them somewhere, so I chose the three, and I think basically they are valid.

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25. Id. at 371, 392 A.2d at 1241.
First of all, there are provisions of the Delaware statutes which provide for their own statutory standards of liability. These are notably in the areas of the unlawful payment of dividends or unlawful stock purchase where the statute says there has to be either willful or negligent conduct of the directors. Also, if the director refuses to produce a stock list, he happens to be ineligible for election in Delaware.

The second category of statutory provisions protect directors against liability, and I have set out the three provisions that are applicable here, and most notable probably, is the fact in section 141(e) that a director’s good faith or reliance on certain material provided to him by the corporation would actually protect him from liability.

The last category are those which I call provisions which ease the burden of liability. One is the right of contribution and subrogation as set out in the Delaware Code which does provide directors with subrogation rights with respect to their collecting back anything due them, and also they have the right of contribution among fellow directors. Last, again, is another provision which eases the burden of liability, the indemnification statute which Mr. Fenton is going to tell you about.

In conclusion, and I suppose there has to be a conclusion,—with due deference to the courts which could reverse me at any moment,—and with the appropriate sense of malaise that I have about whether I found the right words to express appropriately what the Delaware stand is and I would say that the rule in Delaware is not gross negligence, but it is ordinary care, and I believe that the Delaware Law, the Delaware Common Law, supports the notion that the directors are required to act in good faith and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

Also, I think with respect to the Business Judgment Rule that the standard, in making a decision on matters which affect the business and affairs of the corporation, is that the director must exercise his business judgment in the manner he believes, not reasonably believes, but in fact believes in good faith, to be in the best interests of the corporation.

27. Id. § 219(b).
28. See also id. § 172 (which protects directors acting in good faith reliance upon certain materials pursuant to declaration of dividends or stock redemption) and § 174(a) (which protects a director who records his dissent from a resolution or other act).
29. Id. § 145.