DIRECTORS' STANDARD OF CARE UNDER SECTION 35
OF THE MODEL BUSINESS
CORPORATION ACT

BY E. NORMAN VEASEY*

Thank you Mr. Chairman. I am going to limit myself to a perhaps narrower area than you might have perceived also from Rod's overview.¹ I'm not going to talk about the Model Business Corporation Act² in its entirety. I'm going to talk about only one section.

Why are we talking about section 35 of the Model Business Corporation Act? It has not been adopted in Delaware. It has been adopted following its approval by Corporate Laws Committee of the Corporation Business and Banking Section of the ABA in the states of New York, Maryland, Iowa, Florida, Connecticut and California and it is pending in Alabama.³ I might say that a number of those states routinely follow the Model Business Corporation Act. Sometimes the Model Act leads the Delaware law; often it follows the Delaware law. Sometimes it departs from the Delaware law.

But why are we talking about section 35 here since Delaware hasn't adopted it? I think one can argue that it is declaratory of the law of Delaware to a great extent. The law of Delaware is principally embodied in the supreme court opinion in Graham v. Allis-Chalmers⁴ and in sprinklings of jurisprudence throughout cases in Delaware. The standard of negligence, I think, is also illustrated in chancery court opinion in Lutz v. Boas.⁵ The Delaware law ordinarily originates in the General Corporation Law Committee of the Delaware Bar Association. When I was chairman of that committee a few years ago, we considered a preliminary draft of section 35, and at that time we decided not to adopt it. It had not undergone its final refinements at that time. We did adopt at that time the provision that the business and affairs of the corporation shall be managed "by or under the direction of a board of directors." We added the words "under the direction of" recognizing the plain

---


1. See address by Mr. Ward, this issue, p. 244 supra.
2. ABA-ALI, MODEL BUS. CORP. ACT ANN. (Supp. 1977).
3. These states have identical or comparable statutes, enacting portions of § 35. Other states have also adopted comparable statutes. For a comprehensive listing, see id. § 35.
5. 39 Del. Ch. 585, 171 A.2d 381 (Ch. 1961).
fact that the board of directors does not manage the corporation. It hires and is supposed to supervise the managers of the corporation. Section 35 was not quite finished at that time and we felt that even if it were finished in substantially the form in which we were considering it, it was not necessary to adopt it in view of the state of Delaware law. We felt it was probably not desirable to jump into a codification that may prove in the test of time not to be a good standard.

Later, after section 35 was further refined and finally adopted by the ABA committee, the General Corporation Law Committee of the Delaware Bar Association had a subcommittee review it. They decided again not to recommend its adoption at that time, I think for the same reasons: that it was unnecessary and that the Delaware law adequately covered the subject.

The reason I think it is appropriate to discuss it is not only to compare it with the Delaware law which is done in the outline, but because there is a lot of talk abroad that directors need to have certainty. They need to have certainty in deciding whether or not to go on a board of directors. They need to have certainty in knowing what their responsibilities are when the board is faced with a decision to go into a transaction and what are their responsibilities for oversight, for supervising and ferreting out what the managers of the corporation are doing.

Yesterday I received a book called The Board of Directors: Perspectives and Practices in Nine Countries put out by the Conference Board, which is an independent, nonprofit research organization. It gives you a flavor for the different ways that corporate boards' responsibilities are viewed in different countries. Turning to the part of it relating to the United States, with regard to the area of certainty, let me read you a few excerpts from page 101:

One can hardly pick up a U.S. business periodical without coming across a story about a lawsuit mounted by a shareholder or someone else against the directors and officers of a business concern. A commonly held view is that potential liability makes qualified people refuse, or at least hesitate, to serve on corporate boards.

In recognition of directors' exposure to liability, practically all major companies indemnify them against losses sustained personally as a result of legal actions arising out of their activities as board members. Most offer protection for directors

6. See appendix F, this issue, p. 375 infra.
and the corporation alike through directors' and officers' (D&O) insurance. . . .

The U.S. directors contributing to this study hold a wide range of opinions about liability. [They made a survey of directors and that's the basis for a lot of the information in it.] Some of them are personally concerned — 'a sword of Damocles hanging over my and my fellow directors' heads' — one of them says. A commonly cited problem is that not even the most astute lawyer knows where directors' liability begins and ends, save in the most flagrant circumstances of misconduct on his part; the body of law simply has not been developed sufficiently to make the matter clear. A related difficulty, one director observes, is that liability is inevitably proved 'after the fact.' At the time the act was committed — or there was a failure to act — reasonable people can and do differ as to whether the act or inaction was sound. Incidentally, all the members of one of this director's boards are being sued for manifesting what is alleged to have been poor business judgment in a major decision.

Does the Delaware law provide that certainty and/or does section 35 of the Model Business Corporation Act provide that certainty? We are talking not about self-dealing or violations of fiduciary duty. As you note from the outline, the committee of the ABA did not use the word "fiduciary" in talking about section 35.8 We are talking primarily about the area of negligence. Negligence of inside directors and outside directors, negligence in going into a transaction or in failing to act. Those are the kinds of areas in which we are dealing here; we are not dealing with the self-dealing or the fraud situation.

What does the section 35 of the Model Business Corporation Act say? First of all, it says that the business and affairs of the corporation shall be managed "under the direction of the board of directors."9 That is consistent with the Delaware law, which says "by or under the direction of,"10 and is further consistent with the Delaware law in Graham v. Allis-Chalmers11 — that the board of directors should really look to the major policy decisions and should not be responsible for the day-to-day management. In our committee report, when we in the Delaware Bar recommended to the legislature the "under the direction of" language we referred to in our commentary which appears at page [376] of the outline.12

8. Appendix F, this issue, infra at 375.
11. 41 Del. Ch. 75, 185 A.2d 125 (Del. 1963).
12. Appendix F, this issue, infra at 376.
Just a word about the commentary. The General Corporation Law Committee, when it proposes legislation, does develop a commentary which is sometimes explanatory of the material. Some say sometimes it is confusing, but it becomes a part of the submission to the General Assembly and is very often referred to by lawyers to give some gloss on the legislative enactments.

The second part of section 35\(^1\) sets forth the standard that the director is supposed to abide by — that he act "in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinary prudent person in a like position would use under similar circumstances."\(^2\) There is a lot of writing about what that means. I think it is best summarized by the ABA committee itself in their second report that deals with the amendments that they made, appearing in *Business Lawyer.*\(^3\) The standard is the negligence standard of the prudent man and requires the director to exercise his business judgment with his general tools of common sense, practical wisdom and informed judgment. What does, then, the term "like position" mean? Here, I think we are dealing with a very difficult to pin down area that has to be tested on a case by case basis. For example, there may be different standards for a lawyer director, a businessman director, an accountant director, a farmer director, an inside director, etc. The standard may vary with the particular transaction which comes up. For example, if it is a merger and the president of the corporation presents you with financial data showing why the company should go into the merger — why it is in the best interests of the corporation to have this merger — you see pro forma financial statements before and after the transaction, cash flow projections, proposed profit statements, per share earnings, etc. The directors are supposed to vote on this transaction.

The lawyer director may see an antitrust violation in this merger, an antitrust violation that might cost the company money if the Justice Department or the Federal Trade Commission or a private party brings an action. He may also perceive some financial problems, presumably having some expertise in the area. The accountant might see some financial problems; for example, there might be on the face of the papers themselves a latent defect that a trained eye would see. The farmer director might not see it; he might not be expected to see it. Suppose there's a committee of the board of

---

14. Id. at 270.
directors that looks into this particular transaction. That committee hears some experts involved in the business aspects of the transaction and makes a recommendation. That is an example of different circumstances; there is somewhat of a different duty imposed on different directors depending on their degree of expertise or lack of it.

Perhaps the lawyer director might be held liable for not looking at or pointing out the antitrust problems. The accounting director might be held liable for not recognizing a latent defect that any trained eye would see on the face of it; whereas the farmer director might not know and he would not be held liable. It is difficult to say under these circumstances whether these various directors would be held liable for negligence in these situations, either under the Model Business Corporation Act or under the Delaware law. The concept of "like circumstances" is, I think, just a further refinement of the same standard of how the particular director will be judged.

What happened in Graham v. Allis-Chalmers? Rod Ward, I think, has given you sufficient facts in that case to see how that case measures up against the ABA standard. I agree with Rod that criticism of this case is not warranted because the case sets forth a meaningful standard. Let me just go through a few excerpts to give you a little flavor of Graham v. Allis-Chalmers. That was the case where the company lost money because of antitrust violations and the plaintiffs felt that the inside and outside directors should have been able to prevent it. They argued, for example, that the directors were put on notice because of old Federal Trade Commission decrees, and that it was their duty to ferret out and to take steps that it would not be repeated. The court found that only three of the present directors knew of the decrees, and all three of them satisfied themselves that Allis-Chalmers had not engaged in activities that violated those decrees. The court goes on to say that plaintiffs didn't prove in this case, that the directors had actual or imputed notice of the antitrust violations that could have brought damage to the corporation.

I leave to your speculation what would constitute imputed notice. The managers of a company may present the board of directors with large notebooks such as you have here with a lot of information. Suppose that buried on page 172 is a red flag even to the ordinary nonexpert director. Is that imputed notice?

In the Allis-Chalmers case the charge was made that the directors should have put into effect a "system of watchfulness"

16. 41 Del. Ch. 78, 188 A.2d 125 (Del. 1963).
17. See address by Mr. Ward, this issue, p. 244 supra.
which would have brought such misconduct to their attention in ample time to have brought it to an end. There is a U.S. Supreme Court case\(^\text{18}\) referred to in that opinion which the Delaware court said expressly rejected the idea:

On the contrary, it appears that the 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.

\[\ldots\] The very magnitude of the enterprise required them to confine their control to the board policy decisions. That they did this is clear from the record. At the meetings of the board in which all directors participated, these questions were considered and decided on the basis of summaries, reports and corporate records.\(^\text{19}\)

That brings me to the third part of the Model Business Corporation Act:

[directors are] entitled to rely on information, opinions, reports or statements, including financial statements and other financial data in each case prepared by:

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,

(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or

(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation.\(^\text{20}\)

Then it goes on to say,

but he shall not be considered to be acting in good faith if he has knowledge [imputed or actual, it doesn't say] concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.\(^\text{21}\)

---

19. 41 Del. Ch. at 85, 188 A.2d at 130.
21. Id. at 270-71.
Now, what happened in the *Allis-Chalmers* case along these lines? What are you entitled to rely on? The court said about the section of the Delaware statute permitting reliance on the books and records:

These they were entitled to rely on, not only, we think, under general principles of the common law but by reason of 8 Del. C. § 141(f) as well, which in terms fully protects a director who relies on such in the performance of his duties.

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 confidence 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 employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion the Board acted promptly to end it and prevent its recurrence.22

Now, it's section 141(e) of the Delaware corporation law which protects board members given good faith reliance on "the books of account or reports made to the corporation by any of its officers, or by an independent certified public accountant, or by an appraiser selected with reasonable care, . . . or . . . other records of the corporation."23 We noted in the outline24 that this provision appears to be more restrictive than section 35 of the Model Business Corporation Act in its category of outside experts. However, the Delaware courts have impliedly approved board reliance on experts not expressly mentioned in the statute, so that I think that section 141(e) will be relied on broadly.

Perhaps the only definitive Delaware case where outside directors were held liable was *Lutz v. Boas.*25 That was a mutual fund case in which, among other things, the outside directors, then called the nonaffiliated directors, were charged with liability in certain areas — duplicate payments of advisory fees, brokerage commissions, and so on, losses relating from the sale of securities. This is a mutual fund, remember, and the problem was the mutual fund manager and advisor were allegedly damaging the corporation

---

22. 41 Del. Ch. at 85, 188 A.2d at 130.
by doing unnecessary work and by self-dealing. There was no self-dealing on the part of a nonaffiliated director, however, but it is charged that they were liable for letting the corporation, by inaction, be damaged by unearned advisory fees paid to the advisor; the losses resulting from the sale and repurchase of the same securities, and commissions paid due to excessive turnover generally. The court held that the nonaffiliated directors had the same responsibility as ordinary directors of a Delaware corporation.

This case arose not only under Delaware law but under the Investment Company Act. The court said: "These men are prime examples of what can happen when a man undertakes a substantial responsibility with public overtones without any appreciation of his obligation thereunder." The court made certain findings of fact. They gave automatic approval to the management agreement. They did not examine the registration statements carefully. They did not discuss securities at their meeting or discuss other facts. Most of the time at the directors meeting was spent in determining dividends on the basis of worksheets prepared by the managers. The directors did not know who selected securities for purchases or sale. They did not inform themselves about the rate of turnover and how the brokerage business was being distributed. There was an SEC opinion in that case criticizing and holding the directors liable, and Chancellor Seitz went on to say that he adopted the SEC opinion as his own. Here is the portion of the SEC opinion that he adopted as his own:

The record shows that the board of directors gave scant attention to the management of the registrant, made no efforts to be informed concerning registrant policies and whether such policies were being followed, made no decisions concerning purchases and sales of portfolio securities, and generally permitted the registrant to be managed by the [managers] without consultation with or approval by the board as a whole.

On the basis of the record it is evident that the directors failed to discharge the duties and responsibilities as directors, and failed to perform the functions which the prospectus represented they were performing. The prospectus represented that the operations of the registrant are under the supervision and direction of its board of directors, and failed to point out that the [managers] were assuming the functions of the board of directors in directing the operations of the registrant.\(^\text{28}\)

\(^{27}\) 39 Del. Ch. at 608–09, 171 A.2d at 395.
\(^{28}\) Id. at 609, 171 A.2d at 395.
That's the end of the quote from the SEC opinion which Chancellor Seitz adopted. Then he goes on to say: "What is the extent of the liability of these grossly negligent directors?" Then he says: "I think the answer is that even an average attention to duty by the directors would have revealed the fact that the [managers] were being paid for services being rendered by Model." Then he goes on to say why he concludes this. He says then: "I am satisfied that these directors are liable because I think it is clear that had they discharged their responsibilities as to general supervision they would have discovered these violations of Fund's investment policy. It is evident that the negligence of these directors can be considered a proximate cause of the loss to Funds."

I think in summary that it's an open question whether or not section 35 is declaratory of the Delaware law. It does provide some limits, and if the Delaware courts have similar cases they would not be confined to section 35 and they might go beyond those limits. My guess would be that the Delaware courts would apply approximately the same standards as section 35. The Delaware case law provides some more flexibility and perhaps that's argument for retaining the Delaware state of the law in an uncodified status. If you look at the codification, you see so many broad statements, such as "ordinary prudent person" and "like position," etc. It will have to depend so much on the facts of each case that it is impossible to forecast where the courts will go. If you look at the BarChris case, a federal case under section 11 of the Securities Act where the directors signed securities materials, the court went through each director and his role — was he an accountant, was he a lawyer, was he on the committee, did he know, should he have known — and imposed a pretty heavy standard on each of these directors. That was the standard applied under section 11 of the Act that required the directors, when they signed the prospectus, not to sign it negligently, that they not put out material that is misleading and that they have a duty of due diligence. The court there imposed a very heavy standard of due diligence.

Whether or not the court in Delaware would go that far in a nonsecurities context is difficult to perceive. However, even if section 35 were enacted, I don't know that the result would be any different. I think whatever way you approach this question of the liability of

29. Id.
30. Id. at 610, 171 A.2d at 396.
31. Id.
inside directors, outside directors, or negligence — passive negligence or active negligence — is going to depend so much on the facts of each case it would have to be analyzed to some extent like the obscenity case is analyzed. You can't really express it but you know it when you see it.