DAY 3

3.1 Introduction to Directors' Duties and the Duty of Care

- O'Kelly and Thompson – see the duty of loyalty as important and fiduciary but duty of care as aiding this.
- Duty of good faith: controversial → didn't know if it was a subcategory of the other duties, or if it was a stand-alone duty.
    - Note: disjunct between legal doctrine and commercial reality → corporation codes and judiciary focus almost only o the liability of directors, and ignored corporate officers
    - *Gamflat v Stevens* 2009 – found that officers have the same responsibilities and duties as directors
- Directors act collectively through the board – yet when we get to director liability, duties are held individually.

What is the fundamental difference between MBCA and Delaware?

- Delaware law – judge made law – no statute
- MBCA – written into the MBCA is statute and there is duty

Two important underlying themes

- 1. How much discretion should the directors have regarding policy? Should the shareholders be able to direct their policies?
    - Directors discretion: how do you put constraints on director discretion without stemming the innovation and energy of the company
- 2. Shareholder v Stakeholder interests – to what extent can they favour the interests of non-shareholder constituencies in making decisions?
    - To what extent can they look at the long-term interests of the corporation in comparison to short-term interests?
- Note: Marty Lipton – critical of Apple as the institutional investors being harnessed by gaggle of hedge funds forcing them to focus on short-term profits as opposed to long term profitability

Discretion to Determine General Business Policies and Discretion to Consider Non-Shareholder Interest

The fiduciary duty of care: The duty of care arises in two contexts: the decisional setting and basic oversight. It constrains directors and officers in their pursuit of self-interest. Directors have a fiduciary duty of loyalty and a duty of care.

<u>What is the business judgment rule?</u>

The business judgment rule is a rebuttable presumption that:

- **'directors are better equipped than the courts to make business judgments and that the directors acted without self-dealing or personal interest and exercised reasonable diligence and acted with good faith**. A party challenging a board of directors decision bears the burden of rebutting the presumption that the decision was a proper exercise of the business judgment of the board' – *Gries Sports Enters Inc v Cleveland Browns Football Co Inc* (1986) (negative factors that will displace the bjr)
- 'in making the business decision, the directors of a corporation acted **on an informed basis, in good faith and in the honest belief that the action taken was in the bests interests of the company'-** *Aronson v Lewis* (positive factors that will attracted the protection of the bjr)
- Provides the board with a high level of autonomy and discretion – entrepreneurialism.

Discretion to Determine General Business policies

Suppose a corporation is consistently underperforming other corporations engaged in similar business activities. Directors are carrying out their duties in good faith and great attention, but a plausible explanation for the corporation's underperformance is management's insistence on pursuing idiosyncratic business policies. *To what extent should dissatisfied shareholders be able to obtain a trial to determine the appropriateness of the director' business policies?*

Two categories of non-shareholder benefit

- 1. Directors consider interests of others where some rationally related benefit accruing to the shareholders – this is a win/win
- 2. Stakeholders win, shareholders lose.

***Shlensky v Wrigley*, 95 Ill. App.2d 173, 237 N.E.2d 776 (1968) (OKT, p 266)**	
Facts	A minority stockholder brought a derivative suit (shareholders seek to stand in the shoes of the corporation to bring an action against its directors) against the directors of Chicago Nat'l League Ball Club, Inc., seeking damages and an order that the Ds cause the installation of lights in Wrigley Field and the scheduling of baseball games at night. The Board was dominated by Wrigley (also 80% shareholder) and he believed it was going to be negative on the neighbourhood. Plaintiff alleged that every member of the major leagues, other than the Cubs, scheduled substantially all of its home games at night, exclusive of opening days, Saturdays, Sundays, holidays and days prohibited by league rules.
Issue	The issue is whether the court should overrule decisions made by Defendant absent a showing of fraud, illegality or a conflict of interest.
Held	**A court will not interfere with an honest business judgment absent a showing of fraud, illegality or conflict of interest.** Held that P didn't state a cause of action. Reasoning: P didn't show fraud, illegality, or conflict of interest on the part of the directors in making their decision not to schedule night games, *P failed to allege damage to the corp, and P failed to show how the corp's failure to follow the example of other major league clubs in scheduling night games constituted negligence* – any increase in revenue would be offset by the increased costs of installing the lights. There was a need for more information about the damage! Bottom line: Cts. won't intervene in business decisions of this nature. D – had made a business judgment – only way to interfere is to show illegality, fraud or conflict of interest. Plaintiff bears the onus to <u>pierce the business judgment rule.</u> Presumption that the D has acted with *due care – no tainting factors in his decision.* You must show that D is not entitled to the benefit of this presumption. • Policy justifications: BJR a good thing because judges lack business judgment required • And the board has been given broad managerial powers • They take the win/win camouflage approach – consider both shareholder and stakeholder benefit

If vitiating factors are present – **onus shifts to the directors to show that it was entirely fair.**

- Entire fairness is a much more stringent test
- If the company is making a decent profit, then it is fairly easy to show entire fairness.
- *Delaware Court of Chancery – Inri v MFW Worldwide (2013)*– a going private merger and the controlling shareholder was going to takeover the company and get rid of the minority shareholders. Question of which standard would it be determined under. Business judgment rule or entire fairness?
    - Normally a going private merger, would attract the entire fairness because there is a huge conflict of interest (would want to get it as cheap as possible).

- This particular merger, the transaction had been constructed in a way to persuade Chancellor Strime to apply the BJR. The merger was structured in a way that wouldn't go ahead unless 1. Approval by the BOD and 2. Majority of minority shareholders give approval
- Minority shareholders had the ability to blockade the transaction themselves, therefore the court did not need to give them protection.
- Huge incentive to structure a

Remember if the plaintiff fails to pierce the business judgment rule, the case falls down.

Discretion to Consider interests of non-shareholder constituencies

Judges have traditionally granted business judgment rule protections only when directors act in the best interests of the corporation. *But how far does that protection extend when shareholders claim that the officers and directors are impermissibly favouring interests of non-shareholder constituents?*

- There will be times where directors do thing that benefit non-shareholders, but they aren't necessarily trumping the interests of shareholders

***Dodge v Ford Motor Co*, 204 Mich. 459, 170 N.W. 668 (1919) (OKT, p 270)**	
Facts	Two minority stockholders of Ford Motor Co. challenged the company's actions in refusing to pay dividends while expanding the company's facilities and lowering the price of its cars. Henry Ford took the opportunity to grandstand, saying that the company had made too much money and needed to share some of the profits w/ the public.
Issue	The issue is whether Plaintiff shareholders can force Defendant to increase the cost of the product and limit the money invested into expansion in order to pay out a larger dividend.
Held	The **purpose of a corporation is to make a profit for the shareholders**, but a court will not interfere with decisions that come under the business judgment of directors. *A refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done.* Ct. refused to interfere w/ Ford's selling price and expansion plans, but did order a dividend. "A business corp is organized and carried on primarily for the profit of the stockholders." That said, a ct. will give the board the benefit of the doubt wherever possible. The judges are not business experts. It is recognised that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. Plaintiffs are entitled to a more equitable-sized dividend, but the court will not interfere with Defendant's *business judgments regarding the price set on the manufactured products or the decision to expand the business*. The purpose of the corporation is to make money for the shareholders, and Defendant is arbitrarily withholding money that could go to the shareholders. Notably, Ford did not deny himself a large salary for his position with the company in order to achieve his ambitions. However, the court will not question whether the company is better off with a higher price per vehicle, or if the expansion is wise, because those decisions are covered under the business judgment rule.

- Lin Stout: Team production theory – shareholders aren't entitled to be the only group have their interests taken into account, directors are a mediating hierarch and no one team members interests are higher than another
- Law and economics theory: corporation is a fiction – directors there to please the shareholders

What are constituency statutes?
Directors may consider the interests of other constituencies if there is 'some rationally related benefit accruing to the shareholders'. State legislature – generally provide that in determining the best interest of the corporation, directors may consider the interests of suppliers, employees, customers and affected communities.

About 30 states have constituency statutes – but not Delaware. It interferes with the self-image of Delaware law (which is about shareholder primacy), doesn't necessarily need it so much. Also the *Revlon* judgment suggests if it is a win/win then it is fine. Delaware might have felt that it would dilute the director primacy in making decisions, but shareholder primacy in being protected by those decisions and thus didn't need it because directors have managerial discretion in the context of takeover law.

Generally comes into play in the hostile takeover context.

Do they change the basic provisions? Some are mandatory, but most are enabling.

- Maine Bus Corporation Act s 716
    - 'In discharging their duties, the directors and officers **may, in considering the bests interests of the corporation and its shareholders,** consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors'
- Pennsylvania Bus Cop L s 1715
    - (a) 'in discharging the duties of their respective provisions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the **best interest of the corporation**, consider to the extent they deem appropriate:
        - (1) the effects of any action **upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments are located'**

The American Bar Association considered whether MBCA 8.30 should include stakeholders. The committee thought a reference to stakeholder interests, without tying it to shareholder wealth (the ultimate end), would be incredibly dangerous and undermine the effectiveness of the system. They were concerned that the directors would have too much power as they could tie their power to a stakeholder group.

Jonathan Springer – only idiots would think statutes are put in place for stakeholders. They are red herrings; they protect directors in takeovers and no one else.

O'Kelly and Thompson: BJR gives directors a lot of discretion in the win/win scenario and give examples:

- Costo/Walmart: Costco treat employees better than Walmart. Paid them an average of $20 an hour compared to $12 at Walmart and that Costco covered 88% of employees with company covered health insurance.

What are benefit corporations?

- This new form of company that has developed flys in the face of traditional shareholder centered image. Marilyn first state to adopt this corporation in 2010.
- In 2013, Delaware adopted it (20th US jurisdiction to authorise).
- Specific subject chapter – 15 in Delaware Law
- If you are a director of a benefit corporation in Delaware, you are looking at the positive impact on environment, community workers, society in general.
- A tripartite of interests: public benefit, those affected by conduct and shareholders.
- O'Kelly and Thompson – refer to Jack Martell (Governor) – as very upbeat about introducing these corporations into Delaware.
- Benefits: allows directors

Problem 4.1 – O'Kelly and Thompson

Sportswear Inc - $100m to bring all plants into compliance

- For:
- No conflict of interest, illegality or fraud…by the directors
- Could be dependant on where they sit in the field with other countries
- There is quantifiable damage
- Reputation – ethical behaviour of the companies
- Against:
- Not in the bests interests of the company – complying with standards of that country
- No benefit in the short or the long term
- How can you balance the quantifiable damage with possible profits in the future – ie *Wrigley* installation of lights, would that bring increased revenue?

3.2 The Duty of Care, the Business Judgment Rule and *Smith v Van Gorkom*

Business judgment rule: A judge-made doctrine consisting of a rebuttable presumption that directors and officers are better equipped than the cts. to make business judgments, that the directors acted *w/o self-dealing or personal interest*, and that the directors *exercised reason. diligence and acted w/ good faith*. A party challenging a board of directors' decision bears the burden of rebutting the presumption that the decision was a proper exercise of the business judgment of the board.

'Violation of duty of care might arise form inactivity, from grossly negligent behaviour, or from simple negligence'

MBCA ss 8.30 and 8.31

§ 8.30. STANDARDS OF CONDUCT FOR DIRECTORS
(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) *in good faith*, and (*2) in a manner the director reasonably believes to be in the best interests of the corporation.*
(b) **The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances**.
(c) In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on the performance by any of the persons specified in subsection (e)(1) or subsection (e)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.
(d) In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (e).
(e) A director is entitled to rely, in accordance with subsection (c) or (d), on:
(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;
(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or
(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.
§ 8.31 STANDARDS OF LIABILITY FOR DIRECTORS
(a) A director shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as a director, unless the party asserting liability in a proceeding establishes that:
(1) any provision in the articles of incorporation authorized by section 2.02(b)(4) or the protection afforded by section 8.61 for action taken in compliance with section 8.62 or 8.63, if interposed as a bar to the proceeding by the director, does not preclude liability; and
(2) the challenged conduct consisted or was the result of:
(i) action not in good faith; or
(ii) a decision
(A) which the director did not reasonably believe to be in the best interests of the corporation, or
(B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or
(iii) a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct
(A) which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation, and
(B) after a reasonable expectation to such effect has been established, the director shall not have established that the challenged

conduct was reasonably believed by the director to be in the best interests of the corporation; or (iv) a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefore; or (v) receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its shareholders that is actionable under applicable law. (b) The party seeking to hold the director liable: (1) for money damages, shall also have the burden of establishing that: (i) harm to the corporation or its shareholders has been suffered, and (ii) the harm suffered was proximately caused by the director's challenged conduct; or (2) for other money payment under a legal remedy, such as compensation for the unauthorized use of corporate assets, shall also have whatever persuasion burden may be called for to establish that the payment sought is appropriate in the circumstances; or (3) for other money payment under an equitable remedy, such as profit recovery by or disgorgement to the corporation, shall also have whatever persuasion burden may be called for to establish that the equitable remedy sought is appropriate in the circumstances. (c) Nothing contained in this section shall (1) in any instance where fairness is at issue, such as consideration of the fairness of a transaction to the corporation under section 8.61(b)(3), alter the burden of proving the fact or lack of fairness otherwise applicable, (2) alter the fact or lack of liability of a director under another section of this Act, such as the provisions governing the consequences of an unlawful distribution under section 8.33 or a transactional interest under section 8.61, or (3) affect any rights to which the corporation or a shareholder may be entitled under another statute of this stateor the United States.

<u>Policy Arguments for Limiting the Reach of the Duty of Care</u>

Controversial: role of the fiduciary duty of care in ensuring that a corporation's directors carry out their managerial responsibilities with reasonable care and diligence. Everyone agrees that a well-functioning, competent board is an essential ingredient to a corporations long-term success, but substantial disagreement as to the contours of the duty of care.

Most widely adopted definition as modeled after the pre-1998 version of MBCA 8.30(a)(2) – '*with the care an ordinarily prudent person in a like position would exercise under similar circumstances*'. Could be interpreted as making directors liable for any harm to a corporation caused by the director's failure to exercise ordinary care.

In reality, liability for breach of the duty of care has always been rare, and has occurred in circumstances where the director's conduct was egregious. Courts universally recognise that directors are presumptively not liable for breach of duty of care by applying the business judgment rule.

Why do we want to make it so difficult for shareholders to sue directors a breach of duty of care?

- No one would want to be a director and those that were directors would act in an overly risk adverse way that would limit innovation and entrepreneurialism

Joy v North **692 F.2d 880 (1982) (OKT, p 328)**	
Facts	Citytrust (defendant) made a series of questionable loans, sometimes unsecured or exceeding federal statutory limits, to the Katz Corporation (Katz) in connection with Katz's construction of an office building. The loans totaled more than $2.5 million. Citytrust obtained a second mortgage on the office building, and Katz's partnership later turned over title to the building to Citytrust, which assumed Katz's mortgage to an outside lender. Citytrust sold the building, but the buyer defaulted. There is no evidence that the rental income derived from the building is sufficient to meet the obligations assumed by Citytrust. Dr. Athalie Joy (plaintiff) filed a shareholder's derivative claim on behalf of Citytrust Bancorp, Inc. (previously known as Connecticut Financial Services Corporation) (Bancorp), Citytrust's parent company, after making an unsuccessful demand on the board. The suit charged Citytrust, its officers, and directors with breach of trust, fiduciary duty, and federal law. Bancorp's board authorized a Special Litigation Committee to investigate, and the committee recommended dismissing the suit for most defendants and settling with others who may have been negligent. Joy refused to withdraw the lawsuit. The district court took discovery on the committee's competence and independence before granting summary judgment to the outside defendants, concluding that the committee was entitled to the

	protection of the business judgment rule. Joy appealed to the United States Court of Appeals for the Second Circuit.
Held	A corporate officer who makes a mistake in judgment, as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. Further explanation of the business judgment rule and why it gives so much aid to directors. Rationale offered: (1) Shareholders voluntarily undertake the risk of bad business judgment. (2) Cts. recognize that after-the-fact litigation is an imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not readily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. (3) Because potential profit often corresponds to the potential risk, it's in the interest of shareholders that the law not creates incentives for overly cautious corporate decisions. Note that the rule does *not* apply in cases, e.g., in which the corporate decision lacks a business purpose, is tainted by a conflict of interest, amounts to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision. • Not trustees – we want them to take risks • Stupifying disjunction risk and reward • Shareholders aren't that vulnerable

<u>Duty of care in the Decisional setting</u>

- Directors consider whether the authorise a particular course of action, activity or transaction. They are faced with constant tension created by different perspectives and access to information of 'inside' and 'outside' directors.
    - Inside directors are invaluable source of information about the corporations business but can also have blind spots regarding their own business policies and may not always be totally objective
    - Outside directors have a difficult duty of care role.
        - First: much of the detailed information may be possessed by directors or management personnel who have committed to a particular course of action – so to what extent can they rely on this information?
        - Second: directors are usually extremely competent business executives or are otherwise familiar with dynamics of the type of transaction being contemplated by the corporation – given preexisting knowledge, what types of additional information and expertise should the directors seek?
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***Smith v Van Gorkom* 488 A. 2d 858 (1985) (OKT, p 331)**	
Facts	Jay Pritzker owns Marmen who owned New T Corp (this was for the purposes of the merger). Van Gorkom owned TransUnion and was looking for someone to buy them out because they had to much tax credit (a large amount of taxable income). Not enough tax flow and can't reduce tax by offsetting the tax credits. Therefore wanted a merger sale of assets and shares. *To achieve a merger, you need agreement by both directors and shareholders of the two companies that are going to merge and only the directors can initiate the merge.* Van Gorkum was the director who negotiated the transaction with Jay Pritzker. The shareholders brought an action saying the Board made an uninformed decision saying the price was too low (in haste and reckless). Plaintiffs, Alden Smith and John Gosselin, brought a <u>class action suit (related to the duty of candour being embedded in it)</u> against Defendant corporation, Trans Union, and its directors, after the Board **approved a merger proposal submitted by the CEO of Trans Union,**