perspectives. In brief, we find that most boards perform the following actions: hiring, evaluating, and firing the *CEO;* exercising oversight of CEO actions; advising on and consenting to major decisions and policies, typically developed by the CliO; and review ing results. In matters of litigation, senior management i//vcm/s loses in a conflict with the board of directors, provided the board is truly independent of management influence.

WHAT ARE THE RESPONSIBILITIES OF DIRECTORS?

All states define the roles of directors in terms of duties. As we will note, Delaware and Virginia differ in how those duties are interpreted and articulated. In addition, in publicly owned companies, the Securities and Exchange Commission (SEC) imposes regulatory requirements on the corporation and hence the board, particularly with regard to full and timely disclosure of information and insider stock trading. The stock exchanges also have rules that prescribe certain responsibilities, enforced through the standards required for listing on each exchange.

The legal obligations of directors can be broadly summarized by the managerial duties that the law prescribes for directors. The major duties of directors are

- The fiduciary duty
- The duty of loyalty and the duty of fair dealing
- The duty of care
- The duty not to entrench
- The duty of supervision

Let us examine these duties in turn.

The Fiduciary Duty

Central to the role of a director is the fiduciary role—being trustworthy in acting in the best interests of those whom the director represents. This duty has, as we have discussed, the elements of both integrity and competence. What is the duty? It begins with understanding the objective of the corporation.

Paragraph 2.01 of the *Principles of Corporate Governance: Analysis and Recommendations,* assembled by the American Law Institute in 1992, provides the following discourse regarding "The Objective and Conduct of the Corporation"[2]:

(a) Subject to the provisions of Subsection (b) and Paragraph 6.02 (Actions of Directors ... That Have the Foreseeable Effect of Blocking Unsolicited Tender Offers), a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

The director's challenge is how he or she should interpret this fiduciary obligation to pursue the objectives of the business in any given situation. Many corporate governance issues involve subtle questions with regard to specific facts and circumstances.

Paragraph (a) states the economic objective of enhancing profits and shareholder value. This sounds simple but, in fact, involves a fair amount ol complexity. Profit is difficult to measure as well as predict. Peter Drucker has written, "Profit, it cannot be said often enough, is an accounting illusion."[3]

As Drucker points out, there are two dimensions to the reported profit in any period—that which is a result of current period activities harvest ing prior periods' investments and the future profits that will result from the current period's investing. In theory, we might try to measure the amount invested in the future but generally do not do so because it is very difficult. The difficulty arises because it is so tied to the effectiveness of current operations—the maintenance of equipment and facilities, the development of improved processes for efficiency and quality, the building of customer relationships and brand strength, and the growing of effective human resources, as well as more visible research and development (R&D) efforts or the expansion of capacity. In short, there is not only an amount of profit but also a quality attribute of profit that reflects the efforts to generate future profits. Because the two perspectives are so closely intertwined in the operation of a business, it is very difficult, if not to account for them separately with any meaningful accuracy. What is impossible' in the short run is to measure, in any finite way, how well the resources have- been spent. In addition, while a company maybe profitable[1] as defined by accounting rules, its profits may or may not cover the cost of its employed capital.

In fulfilling a fiduciary duty, directors must consider that the objective

of the corporation also includes enhancing *stockholder gain.* This is a broader term that implies everything that contributes to strengthening the economic efforts and value of the corporation. While profit may be the legal objective of the corporation, profit is a result of how well the corporation is functioning. Therefore, in order to create profit as going concerns, corporations also must have the objectives of creating customers and meeting their needs efficiently and effectively in a competitive environment, which requires capital resources and investments, as well as human resources in the form of motivated, competent, and committed people. These objectives support not only the creation of profit but also the enhancement of stockholder gain. There is a cause and effect at work that must be understood. This, too, allows much room for well-intended interpretation.

Because corporations, their customers, and their employees exist in the greater society, how well that society functions has a direct impact on the profitability of a business. Reflecting this concept, paragraph (b) addresses social responsibilities. This paragraph allows that corporations may devote resources to social causes even if doing so does not enhance profit or shareholder gain. Taking a long view, though, we may see that fulfilling social responsibilities enhances society, which benefits customers, employees, and shareholders alike, and thus contributes to the future profitability of the business to the degree that it facilitates creation of a more stable and prosperous society.

The Duty of Loyalty and the Duty of Fair Dealing

By assuming his or her office, the corporate director commits allegiance to the enterprise and acknowledges that the best interests of the corporation and the shareholders must prevail over any individual director's interest. The basic principle of this duty of loyalty is that the director should not use his or her corporate position to make a personal profit or gain other personal advantages.[4]

The duty of fair dealing can be viewed as a component of the duty of loyalty, requiring that all transactions with the corporation be handled in a forthright and open manner that is fair to the interests of the corporation. Specifics of these duties are provided below.

Paragraph 5.05 of the *Principles of Corporate Governance: Analysis and Recommendations* provides the following discussion regarding "Taking Corporate Opportunities by Directors or Senior Executives":

General Rule: A director or senior executive may not take advantage of a corporate opportunity [to be defined below] unless:

(1) The director or senior executive first offers the corporate opportunity to the corporation and makes disclosure concerning the conflict of interest and the corporate opportunity.
(2) The corporate opportunity is rejected by the corporation; and
(3) Either
  (a) The rejection of the opportunity is fair to the corporation;
  (b) The opportunity is rejected in advance, following such disclosure, by the disinterested directors, or, in the case of a senior executive who is not a director, by a disinterested superior, in a manner that satisfies the standards of the business judgment rule [details of this rule are provided with the discussion of the duty of care]; or
  (c) The rejection is authorized in advance or ratified, following such disclosure, by disinterested shareholders, and the rejection is not equivalent to a waste of corporate assets.

Definition of a Corporate Opportunity: For purposes of this section, a corporate opportunity means:

(1) Any opportunity to engage in a business activity of which a director or senior executive becomes aware, either:
  (a) In connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or
  (b) Through the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation; or
(2) Any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage. . . .

Thus, in general, a corporate opportunity is an opportunity to engage **in business of which a director learns and believes would be of interest to the corporation. A director may not take advantage of such opportunities unless he or she first offers the opportunity to the corporation, revealing a personal interest, and the corporation rejects the opportunity.**

Paragraph 5.06 of the Principles of Corporate Governance: Analysis and Recommendations provides the following discussion related to "Competition with the Corporation":

General Rule: Directors and senior executives many not advance their pecuniary interests by engaging in competition with the corporation unless either:

(1) Any reasonably foreseeable harm to the corporation from such competition is outweighed by the benefit the corporation may reasonably be expected to derive from allowing the competition to take place, or there is no reasonably foreseeable harm to the corporation from such competition;
(2) The competition is authorized in advance or ratified, following disclosures concerning the conflict of interest and the competition, by disinterested directors, or in the case of a senior executive who is not a director, is authorized in advance by a disinterested superior, in a manner that satisfies the standards of the business judgment rule (paragraph 4.01); or
(3) The competition is authorized in advance or ratified, following such disclosure, by disinterested shareholders, and the shareholders' action is not equivalent to a waste of corporate assets. . . .

Similar to the situation of business opportunities, directors in general may not seek monetary gain by engaging in competition with the corporation. This stipulation may be altered if the predicted benefits to the corporation outweigh the foreseeable harm, as determined by the corporation, or if the corporation authorizes the competition after the director reveals his or her personal interest.

Duty of Care

It is incumbent on directors to act carefully in carrying out their responsibilities. This is only common sense, but it is a legal requirement as well.

Paragraph 4.01 of *Principles of Corporate Governance: Analysis and Recommendations* provides the following discussion related to the duty of care[7]:

A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable.

(1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefore. The extent of such inquiry shall be as the director or officer reasonably believes to be necessary.
(2) In performing any of his or her functions (including oversight functions) a director or officer is entitled to rely on materials, and persons in accordance with 4.02 and 4.03 (reliance on directors, officers, employees, experts, other persons, and committees of the board).

(a) Except as otherwise provided by statute or by a standard of the corporation and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling the duty under this Section with respect to any delegated function if the reliance is in accordance with paragraphs 4.02 and 4.03.
(b) A director or officer who makes a business judgment in good faith fulfills the duty under this section if the director or officer:
  (1) Is not interested in the subject of the business judgment.
  (2) Is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances, and
  (3) Rationally believes that the business judgment is in the best interests of the corporation
(c) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of duty of care, including the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

In summary, the duty of care, in general, requires a director to act in the best interests of the corporation and with the care reasonably expected of “an ordinary prudent person." The director also has the duty to be informed to make necessary inquiries to arrive at this state. This duty, however, allows the board to delegate functions to and rely on others, including other directors, officers, employees, experts, and board committees. Such delegation and reliance do not negate the board's ultimate responsibility for oversight, however.

What is being addressed is the reality that a director cannot know everything nor be totally expert in every facet of a business. While they have the duty to be very careful in determining the facts, directors can on management and experts for information they do not have and judgements about which they are not expert. This raises the questions of what they should know – when they can claim ignorance as a defense. The answer, as usual, is that it depends on the situation. One of the key skills

of an effective director is to understand what is relevant and to persistently seek that information, particularly when he or she has or should have a feeling of discomfort with the situation. It also emphasizes the importance of having competent and trustworthy managers and advisers, which is one more aspect of the duty of care—choosing these people well.

The Duty Not to Entrench

There is some evidence that the Delaware courts are in the process of creating and imposing on directors another fiduciary duty, a "duty not to entrench." There is a body of opinion that if a corporation is not performing well, changes should be made in management. If the problem can be tracked beyond management to a board that is not fulfilling its responsibilities, changes need to be made there as well. There are many examples of companies with poor performance where the board and management continue in place without successfully addressing the issues—in effect, they become entrenched. It emerges as an issue when a board attempts to block a change-of-control transaction either through the sale of the company or in a proxy fight where dissident shareholders attempt to elect a new slate of directors.

Not all opposition to change of control, however, is evidence of entrenchment. Many times, directors think that the motives of the other party or parties attempting to force change do not represent the best interests of the shareholders as a whole, and as a result, the directors are duty bound to oppose the effort. In many cases they are correct in doing so. Fulfilling the duty not to entrench depends more on following good business practices in evaluating the corporate performance and the performance of management and the board than on complying with the law.

Some observers advocate term limits to avoid entrenchment. This assumes that all directors are motivated to entrench themselves and that a board is incapable or unwilling to deal with poor performers—which is not a universally valid assumption. Further, it ignores the value of continuity and experience. While it does ensure against entrenchment, it deprives boards that are working well of effective directors at a time when getting good directors is not an easy task.

The Duty of Supervision

The duty of supervision is an element of the duty of care; it deals with the effectiveness with which directors exercise their oversight responsibilities. The duty of supervision addresses what directors should know about the

operations of management, how they should come to know it, and what they should do when there is an issue or problem requiring attention.

As an initial step in fulfilling this duty, the board must establish policies of ethics and disclosure that set the standards for behavior of directors and senior executives. The board also must ensure that there are internal controls in place to provide accurate reporting of what is going on in the corporation. This control function is generally the responsibility of the Audit Committee of the board. The board also must establish policies addressing which decisions require board approval and what information the board should regularly receive about the performance of the corporation and its various entities.

Perhaps the most important task associated with the duty of supervision is the regular meeting of the board to discuss the performance of the organization and to ask penetrating questions of management. One of the critical skills for a director is the intuitive sense of what needs to be questioned and the willingness to be persistent in pressing for access to relevant information. Directors must know what they need to know and insist that it be provided.

Dealing with Hostile Takeover Offers

Dealing with hostile offers for the company is another particularly important and difficult responsibility. Because such offers happen very infre quently, directors are often not well informed on this topic. An additional complicating factor is the tendency for hostile offers to end up in litigation as a result of their very high visibility with shareholders.

Paragraph 6.02 of *Principles of Corporate Governance: Analysis and Recommendations* presents the following discussion of "Action of Directors That has the Foreseeable Effect of Blocking Unsolicited Tender Offers"[8]:

> **(a)** The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer, if the action is a reason able response to the offer.
>
> **(b)** In considering whether its action is a reasonable response to the offer:
>
> **(1)** The board may take into account all factors relevant to the best inlerests of the corporation and shareholders, including, among other things, questions of legality and whether the offer, if successful would threaten the corporation's essential economic prospects; and
>
> (2) The board may, in addition to the analysis under 6.02 (b)(l), have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long term interests of the shareholders.

(c) A person who challenges an action ol Ihe board on the ground that it fails to satisfy the **standards of Subsection** (a) has the burden of proof that the board's action is an **unreasonable** response to the offer.
(d) An action that does not meet the **standards** of Subsection (a) may be enjoined or set aside, but the directors who authorize such an action are not subject to liability for damages II their conduct meets the standard of the business judgment rule | paragraph 4.01(c)].

In summary, boards may act to block hostile takeover bids for the corporation when, after having considered carefully what is in the best interest of the corporation and shareholders, they make the judgment that the takeover may jeopardize the viability of the corporation. This means that they can consider the impact on groups other than the shareholders, as well as other factors that they consider relevant.

WHAT STANDARD DETERMINES IF DIRECTORS HAVE MET THEIR RESPONSIBILITIES?

In the United States, the laws of the states and the regulations of a number of government agencies, at both the state and federal levels, spell out the duties and responsibilities of directors and establish the standards of performance for directors that define their obligations. Certain court rulings provide insight into these standards of performance for directors.

Legal challenges to decisions of a board of directors typically come from stockholders who feel that the board that has been chosen to represent their interests has somehow failed in its duties. Courts traditionally have been extremely reluctant to overturn or second-guess decisions made by a board of directors. This sentiment is captured in the following opinion from a Delaware court issued in 1988 in the *Stevens & Co. Shareholders Litigation* case:

> Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is a great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.

As a result of this traditional reluctance of courts to become involved in corporate governance and decision making, the business judgment rule developed. The business judgment rule, which also was presented earlier in this chapter in the citing of paragraph 4.01 (c) of *Principles of Corporate Governance: Analysis and Recommendations,* is expressed in another Delaware court ruling in the case of *Aronson v.* LEWIS in 1984:

> Under the general business judgment rule, there is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company."

Regarding the Delaware ruling, a *presumption* means that the conclusion is drawn unless there is evidence to the contrary and that the burJen of proof is on the party asserting the claim, not on the board of directors defending its action. As a practical matter, if a court determines lliat the business judgment rule applies in a given case, the decision of the board of directors will be upheld. The business judgment rule does not apply if the challenging stockholder(s) can convince the court that in reaching its decision, the board of directors violated one of its fiduciary 11uties, traditionally the duty of care or the duty of loyalty.

The business judgment rule is alive and well in most states. The Delaw ware courts, however, have become increasingly assertive in recent years, and the health of the business judgment rule is not as certain there. In *Brehm v. Eisner* in 2000, a Delaware court held

> Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to any rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

What the court is saying is that it is going to look very carefully at the presumption that directors have fulfilled their duties. If there is sufficient evidence, the failure to fulfill other duties can override the business
judgement rule. If the directors have violated the duty of care, for instance,
or did not act in good faith, they cannot get protection under the business
inclement rule.

spread to other states. Even in Delaware, the courts are mainly reviewing and challenging the processes and methods a board employs to reach a challenged decision and are still generally reluctant to attack or overturn a board's decision on substantive grounds.

In Virginia, the standard for how directors are required to discharge their fiduciary duties is found in Virginia Code Section 13.1-690 as follows:

> A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation.

What is unusual about Virginia is that the Virginia courts have interpreted this section simply to require a board of directors to follow a good process in reaching its decision. If a good process is followed, the Virginia courts will not review the substance, reasonableness, or even the rationality of a board's decision under Section 13.1-690.

INTERPRETATION OF THE DUTY OF CARE

As stated earlier, the duty of care requires a board of directors to act in good faith and to make *informed* business decisions. As we have pointed out, the consequences of breaching the duty of care are severe because the business judgment rule does not apply, and the board of directors must establish the "entire fairness" of its decision. *Entire fairness* means that the shareholders have been, when all things are considered, treated fairly—that the result is fair without regard to how the board arrived at its decision.

Prior to 1985, courts generally assumed that a board of directors satisfied its duty of care in reaching a decision. A board had to go out of its way to breach its duty of care. In 1985, a Delaware court held in *Smith v. Van Gorkom* that "the duty of care includes a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."

The facts in *Van Gorkom* are instructive and include

- The board of directors had no advance notice that a board meet ing was to include consideration of the sale of the company.
- The board agreed to sell the company after a 2-hour meeting.
- The board had no information as to valuation of the company or alternatives such as other potential buyers.
- In effect, a strong-willed chairman rammed through a sale of the company without many questions from or involvement on llupart of the other directors.

The Delaware law has evolved to an *objective* "reasonable person" test: Have the directors acted in good faith and with the degree of care that the ordinarily prudent person would have exercised? To satisfy the duly of care in Delaware, directors must consider all material information reasonably available.

Virginia law is very different. Duty of care for a Virginia corporation is reviewed under a *subjective* good faith standard. In *WLR Foods* in 1995, ,a Virginia court held

> A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation. Good faith is measured by the directors' use of an informed decision-making process and the procedural soundness of the decision-making process, and not by a substantive evaluation of the directors' conduct or by the rationality of the decision made.

As noted earlier, the emphasis in Virginia is on the process employed rather than on the attributes of the decision itself.

Duty of Care Commandments

In order to ensure proper execution of their duty of care, directors should abide by the following "commandments," or rules of guidance. Conscientious boards likely adhere to these in all substantial decision-making matters.

The board is likely to have met its duty of care if it

- Engages experienced legal counsel to design and manage the governance process and maintain appropriate records of the pro ceedings.
- Does not rush important decisions; at least not unnecessarily.
- Gives board members adequate prior notice of important busi ness to be conducted at a meeting.
- Distributes major documents or position papers to board mem-BERSHIPS well in advance of meetings.
- IF possible, has one or more informational meetings, follows up wilh **distribution** of additional information in response to questions, and convenes subsequent discussion and action meetings.
- Provides board members with adequate information to make an informed decision, including
  - Access to opinions of expert advisers
  - Management analysis and recommendations

- Identification of and information on alternatives
- Fairness opinions
- Does not submit to the pressures of a domineering CEO and/or others who clearly have committed to a decision prior to the board's discussions.

If the board follows a sound process, courts in Virginia and, to some degree, in most other states will not overturn a decision on substance in duty-of-care cases.

THE DUTY OF LOYALTY IN PRACTICE

Consequences of breaching the duty of loyalty are also severe. Again, the business judgment rule docs not apply, and the board of directors must establish that the challenged transaction was fair.

As with the duty of care, there are certain "commandments" that establish a list of required behaviors for conscientious boards. If these directives are followed, problems with the duty of loyalty are typically easily avoided.

The duty of loyalty includes the following:

- An interested director must fully disclose any conflict of interest and the basis for it when the issue arises and in advance of relat ed discussions and decisions.
- The interested director must not unduly influence discussion of the transaction, may need to leave the discussion, and almost cer tainly should abstain from voting on the issue.
- The proposed issue must be resolved by a majority of the disin terested directors.

INDEMNIFICATION OF DIRECTORS

It is a general practice for corporations to indemnify directors against liability for their legal actions. This means that the directors are not personally liable for any damages that may result from legal acts of the board to the extent that there are corporate assets to cover any awards to plaintiffs. Most corporations purchase directors and officers liability insurance (D&O coverage) as part of their indemnity program. Certain behaviors are, by statute, excluded from indemnification. These matters are covered in more detail in Chapter 11.