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Corporate Governance II – Accountability Rules

Franklin A. Gevurtz
Pacific McGeorge School of Law, fgevurtz@pacific.edu

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FRANKLIN A. GEVURTZ*

Corporate Governance Part II—Accountability Rules†

Corporate governance—the system by which companies are directed and controlled—involves the allocation of power and the imposition of responsibility. Part I of the United States National Report on Corporate Governance dealt with the allocation of power by examining the various institutions and rules which dictate who directs and controls companies. This part of the Report deals with the imposition of responsibility by examining rules of accountability under which those who control companies may become liable for the decisions they make.[1]

I. Duties

A. *Directors' Duty of Care and Good Faith*

Corporate directors in the United States have a duty of care.[2] The questions are how do courts measure whether directors breached this duty, and to whom does the duty run. To answer these questions, it is helpful to start by separating out two types of cases.

One common type of claim against directors for violating their duty of care involves the allegation that the directors were inattentive while subordinates harmed the corporation. In these cases, so long as there is no conscious decision by the board, courts generally require directors to conform to the standard of a reasonably prudent person in similar circumstances[3]—in other words, courts apply the same basic standard used throughout the tort law of negligence. In applying this test, liability depends upon the circumstances, such as the presence of "red flags" which should have alerted the directors to a problem,[4] and whether the directors made any effort to monitor, or establish a system to monitor, what was going on.[5]

* Distinguished Professor and Scholar, University of the Pacific, McGeorge School of Law; Director, Pacific McGeorge Global Center for Business & Development.

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1. It should be noted that rules and institutions which allocate power also have an accountability function insofar as the quality of decisions may impact the ability to maintain power (for example by impacting prospects for a hostile takeover).

2. *E.g.*, Model Bus. Corp. Act § 8.30.

3. *E.g.*, Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981).

4. *E.g.*, *In re* Abbott Labs. Derivative S'holders Litig., 293 F.3d 378 (7th Cir. 2002).

5. *E.g.*, Stone v. Ritter, 911 A.2d 362 (Del. 2006).

Things change when the complaint is not that the directors were inattentive, but, rather, that the directors made a poor, or arguably poor, business decision. Such a complaint causes courts to turn to the "business judgment rule."[6] The idea underlying the rule is that courts should exercise restraint in holding directors liable for (or otherwise second-guessing) business decisions. Once courts in the United States go beyond the general concept of judicial restraint, however, a lack of consensus emerges as to exactly what the business judgment rule really is.

Many judicial expressions of the business judgment rule in the United States simply state that corporate directors are not liable for their decisions unless the plaintiff shows the directors were in a conflict of interest or failed to act with good faith and with reasonable diligence.[7] This, however, is only stating that one who challenges a decision of the board must show a breach of duty, which is hardly a surprising proposition. The real question is whether the business judgment rule changes what one must show to establish a breach of duty. In some (older) court opinions, the answer is no, as they continue to apply concepts of ordinary negligence even in cases of business decisions.[8] The vast majority of courts in the United States, however, view the business judgment rule as altering the standard for imposing liability. At the most extreme, a few courts consider the rule to command an approach under which directors are not liable for a disinterested decision so long as they act in good faith.[9] This, however, is also an outlier view. Most courts are in the middle. For example, the Delaware Supreme Court settled on the notion that the business judgment rule embodies a standard of gross negligence.[10] Another middle ground approach in the United States is to draw a distinction between challenges based upon the substantive merits of the directors' decision and challenges based upon the process the directors used to make the decision. The notion is that the business judgment rule calls for less (or even no) judicial scrutiny of the merits of the directors' decision, as opposed to the process the directors used in arriving at the determination.[11]

Regardless of the standard applied, it is rare for courts in the United States to hold directors liable for a disinterested decision under the business judgment rule.[12] Opinions differ as to whether extending this exalted status to directors, as opposed to, say, doctors,

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6. *E.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984).
7. *E.g.*, *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).
8. *E.g.*, Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940).
9. *E.g.*, Kamin v. American Express Co., 86 Misc. 2d 809, 383 N.Y.S.2d 807 (1976).
10. *E.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
11. *E.g.*, Auerbach v. Bennett, 46 N.Y.2d 619, 394 N.E.2d 994, 419 N.Y.S.2d 920 (1979).
12. *E.g.*, Zupnick v. Goizueta, 698 A.2d 384 (Del. Ch. 1997).

is justified.[13] Yet, even this slight chance of liability has prompted state legislatures to enact further protections for directors. In the most common form, as illustrated by Section 102(b)(7) of the Delaware General Corporation Law, these statutes allow corporate charters to contain provisions waiving damage claims against directors for breach of duty, except if the breach involves certain categories of conduct. Among the categories of conduct not subject to a liability waiver under Section 102(b) (7) are breaches of the duty of loyalty, and, critically, acts not in good faith.

As a result, good faith effectively has become the standard for disinterested conduct by directors for the numerous Delaware corporations whose certificates contain the exculpatory provision allowed by Section 102(b)(7). This, however, raises the question what is good faith. Traditionally, the answer seemingly focused on whether the directors believed their decision was in the best interest of the corporation,[14] which, in turn, courts almost irrefutably presumed to be the case in the absence of a conflict of interest.[15] Recent Delaware court decisions have left the door open to other interpretations of good faith. For example, in *Disney*,[16] the court stated that "an intentional dereliction of duty, a conscious disregard for one's responsibilities" could constitute a lack of good faith even in a case in which there is no conflict of interest. As examples of such a dereliction (beyond just acting with a purpose other than to advance the interests of the corporation) the court listed intentional violations of law and intentional failures to act in the face of a known duty to act. This means that even inattention can be in bad faith if the directors knew they should have paid more attention—which, in turn, courts may infer from a sustained or systematic failure to exercise oversight, such as not even making an effort to establish a system to monitor.[17]

Finally, to whom do directors owe their duty of care and good faith? The basic answer is to the corporation (as measured by profit maximization) and its shareholders.[18] Courts in the United States generally refuse to recognize an enforceable duty toward other stakeholders in the corporation, such as creditors, employees or the like—with a possible exception for creditors of insolvent corporations.[19] Indeed, courts have stated that directors might breach their duty by sacrificing profit maximization and the interests of the shareholders

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13. *E.g.* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?* 67 S. Cal. L. Rev. 287 (1994).

14. *E.g.*, Stern v. General Electric Co., 924 F.2d 472, 478 n. 8 (2d Cir. 1991).

15. *E.g.*, Johnson v. Trueblood, 629 F.2d 287 (3rd Cir. 1980).

16. *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

17. *E.g.*, Stone v. Ritter, 911 A.2d 362 (Del. 2006).

18. *E.g.*, Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).

19. *E.g.*, North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

in favor of creditors, employees and the like.[20] This, however, is bark rather than bite. Application of the business judgment rule, reinforced in some states by statute, effectively leaves the balancing of interests between shareholders and other corporate stakeholders within the largely unchecked discretion of the board of directors.[21]

B. *Directors' Duty of Loyalty*

The directors' duty of loyalty typically arises in one of two contexts: taking for oneself an opportunity which the director should have presented to the corporation, and, of far greater frequency and importance to corporate governance, transactions in which directors have a conflict of interest. On the former, suffice it to say that courts have developed a variety of tests to determine when an opportunity properly belongs to the corporation.[22]

The approach to conflict of interest transactions in the United States results from a blending of statutory provisions and judicial doctrine. Under this approach, essentially, conflict of interest transactions are voidable unless at least one of three things occurs: (1) approval by disinterested directors, (2) approval by the shareholders, or (3) proof that the transaction is fair.[23] Application of this approach raises issues both under the individual prongs and with respect its disjunctive nature.

The one prong of this approach which most clearly can stand on its own is proof that the transaction is fair. In other words, under state corporate law in the United States, there is no requirement that shareholders or disinterested directors approve a transaction entered entirely on the authority of conflicted directors (or officers) if the court concludes it is fair.[24] Proof of fairness involves issues of process (particularly disclosure of material facts to any disinterested decision makers[25]) and substance (that the transaction serves a corporate purpose[26] and that the terms are as good as the corporation would have received when dealing with a stranger[27]). Critically, the burden of proof is on the conflicted directors, and, in marked distinction to the deference shown to disinterested decisions under the business

20. *E.g.*, Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).

21. *E.g.*, Franklin A. Gevurtz, *Shareholders Democracy: United States' Perspective*, 2008-6 TIJDSCHRIFT VOOR ONDERNEMINGSBESTUUR 145.

22. *E.g.*, Franklin A. Gevurtz, CORPORATION LAW §§ 4.2.7, 4.2.8 (2000).

23. *E.g.*, Model Bus. Corp. Act §§ 8.60-8.63.

24. *E.g.*, Mariciano v. Nakash, 535 A.2d 400 (Del. 1987).

25. *E.g.*, State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co., 64 Wash. 2d 388, 391 P.2d 979 (1964).

26. *E.g.*, Fill Bldgs., Inc. v. Alexander Hamilton Life Ins. Co., 396 Mich. 453, 241 N.W.2d 466 (1976).

27. *E.g.*, Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

judgment rule, courts generally resolve doubts on fairness against the conflicted directors.[28]

Less clarity exists as to the impact of disinterested director approval of conflict of interest transactions. Most statutes[29] and many court opinions[30] suggest that such approval cures the conflict, so that any further judicial review of the transaction is under the deferential business judgment rule as if there was no conflict to begin with. Other statutes[31] and court opinions[32], however—presumably reflecting a lingering unease with directors dealing with other directors—continue to call for judicial review of the transaction's fairness. In any event, this prong forces courts to resolve who is a disinterested director; which generally entails fact intense scrutiny rather than categorical rules.[33] Statutes vary as to how many disinterested directors must vote to approve the transaction in order to cure a conflict.[34] The one clear rule for this prong is that directors in a conflict must disclose all material facts to the disinterested directors.[35]

The impact of shareholder approval—but only if there is full disclosure of material facts[36]—largely depends upon what sort of shareholders voted to approve. Approval by shareholders, who themselves are in a conflict of interest, still leaves the court demanding proof of the transaction's fairness.[37] Approval by shareholders who have no conflict—at least if they own a majority of the stock[38]—cures the conflict and forces the challenging party to prove the transaction was so undeniably without merit as to amount to a "waste" of corporate assets, which even a majority vote of shareholders cannot save from attack.[39] To establish waste, the plaintiff must show that no reasonable person would say that the corporation received the equivalent to what it paid.[40]

In many instances, such as compensation for senior executives who are also members of the board, the existence of a conflict of interest triggering these rules is obvious. When there is no disinterested approval for the compensation, the court will carefully review whether the compensation is fair to the corporation and there is a

28. *E.g.*, Lewis v. S.L.& E., Inc., 629 F.2d 764 (2d Cir. 1980).

29. *E.g.*, Model Bus. Corp. Act §§ 8.61(b)(1), 8.62.

30. *E.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114 (Del. 2006).

31. *E.g.*, Calif. Corp. Code § 310(a)(2).

32. *E.g.*, Cookies Food Products, Inc. v. Lakes Warehouse, Inc., 430 N.W.2d 447 (Iowa 1988).

33. *E.g.*, In re Infousa, Inc. Shareholders Litigation, 2007 WL 2419611 (Del. Ch.).

34. *Compare* Calif. Corp. Code § 310(a)(2) *with* Model Bus. Corp. Act §8.62(a).

35. *E.g.*, Model Bus. Corp. Act § 8.62(b)(1).

36. *E.g.*, Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

37. *E.g.*, Model Bus. Corp. Act §§ 8.61(b), 8.63(a), (c); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

38. *See* text accompanying note 56 *infra*.

39. *E.g.*, Aronoff v. Albanese, 446 N.Y.S.2d 368 (App. Div. 1982).

40. *E.g.*, Michelson v. Duncan, 407 A.2d 211 (Del. 1979).

substantial chance that the court will invalidate the deal.[41] The common practice of gaining approval of compensation by disinterested directors or shareholders generally triggers the deferential business judgment rule or waste standard under which it would be extremely rare for a court to strike down even the large compensation packages to which senior executives in the United States have grown accustomed.[42]

In other sorts of transactions, it may be arguable whether a conflict of interest actually exists. Courts have generally eschewed any bright line test for determining what constitutes a conflict of interest.[43] Even statutes purporting to provide a bright line test, in fact, provide more of a general standard—largely whether directors, or parties closely related to the directors, have a financial interest in the transaction that might reasonably be expected to influence the directors' judgment.[44]

C. *Controlling Shareholders*

Shareholders (even those owning a controlling block) generally have, under prevailing law in the United States, no fiduciary duties when they act solely in their role as shareholders.[45] Hence, shareholders generally can sell a controlling block of stock at whatever price they can get[46] (except if the sale is to a buyer who, the seller should know, will loot the corporation[47]). Shareholders also are free to vote their shares to favor their own interests.[48] An exception in some jurisdictions exists for shareholders in closely held corporations. There, some courts have held that shareholders, even when voting their stock, have a fiduciary duty toward each other.[49]

The situation changes when controlling shareholders go beyond exercising their power as shareholders and are in a position to use their influence over the corporation's board of directors. Specifically, courts may treat a transaction between the corporation and a controlling shareholder as a conflict of interest for the board approving the transaction. As a result, the court will require the controlling share-

41. *E.g.*, Wilderman v. Wilderman, 315 A.2d 610 (Del. Ch. 1974).

42. *E.g.*, *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

43. *E.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993).

44. *E.g.*, Model Bus. Corp. Act § 8.60(1).

45. *E.g.*, Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. 1996).

46. *E.g.*, Zetlin v. Hanson Holdings, Inc., 48 N.Y. 2d 684, 397 N.E. 2d 387, 421 N.Y.S. 2d 877 (1979).

47. *E.g.*, DeBaun v. First Western Bank & Trust Co., 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975).

48. *E.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).

49. *E.g.*, Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976). *But see* Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993).

holder to prove the fairness of the transaction to the corporation and the minority shareholders.[50]

It is not always clear when a shareholder is in a position to control the board for purposes of requiring fairness review of transactions involving this shareholder. Owning a majority is generally enough for courts to presume control.[51] Finding control below a majority depends upon the specific facts.[52] Moreover, some transactions with controlling shareholders—such as a dividend received proportionately by all shareholders—do not involve a *conflict* of interest. For such a conflict to exist, the controlling shareholder must receive something to the exclusion of the minority shareholders and the corporation.[53]

Proof of fairness generally entails the same inquiry into process (disclosure) and substance, with the burden of proof on the defendant, as is the case with conflict-of-interest transactions generally.[54] One difference is that, so long as the transaction entails fair process and fair price, some courts may not require a corporate purpose be served by a transaction in which the majority forces the minority to sell out their shares.[55] The notion of a controlling shareholder seemingly rules out the prospect of curing the conflict through approval by disinterested directors or shareholders—albeit, approval by a negotiating committee of independent directors or approval by a vote of a majority of the minority shareholders may help establish the fairness of the transaction, for instance by shifting the burden of proof to the plaintiff to show unfairness.[56]

II. ENFORCEMENT

Since, as stated above, directors owe fiduciary duties to the corporation and the shareholders, enforcement of fiduciary duties falls largely to actions for recovery by the corporation or the shareholders. A sufficiently egregious case of breach of fiduciary duty might trigger a criminal prosecution as a species of theft[57]; but criminal enforcement of directors' fiduciary duty is rare in the United States.[58]

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50. *E.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
51. *E.g.*, Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987). *But see* Beam v. Martha Stewart, 845 A.2d 1040 (Del. 2004).
52. *E.g.*, Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110 (Del. 1994).
53. *E.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
54. *E.g.*, Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110 (Del. 1994).
55. *Id. But see* Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 483 N.Y.S.2d 667, 473 N.E.2d 19 (1984).
56. *E.g.*, Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110 (Del. 1994).
57. *E.g.*, Jeffery Bauman et al, CORPORATIONS LAW AND POLICY, MATERIALS AND PROBLEMS 157-58 (5th ed. Supp. 2006) (discussing prosecution of Tyco CEO, Dennis Kozlowski).
58. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability*, 42 Hous. L. Rev. 393, 394 (2005).

Moreover, shareholders (at least in a corporation with more than a few shareholders[59]) may only bring an action to recover in their own right when the breach of fiduciary duty causes them direct harm, rather then lowering the value of their shares through harm to the corporation.[60] What this means is that the typical claim for breach of fiduciary duty—outside of the merger and acquisition context in which disappointed shareholders often are able to bring class actions for direct harm—is an action for recovery by the corporation. This creates an obvious problem if directors or controlling shareholders end up deciding whether the company will enforce its claim. The solution in U.S. law is to allow individual shareholders to bring what is called a derivative lawsuit for recovery by the corporation.

Standing requirements to bring a derivative lawsuit in the United States are rather liberal. There is no minimum amount of shares which the plaintiff(s) must own. The plaintiff must be a shareholder throughout the lawsuit and must meet a bare bones notion of being an adequate representative by not pursuing some too obvious personal agenda.[61] Being a front for an attorney who brings the suit for the fees, however, is normal and acceptable.[62] On the other hand, to prevent persons from buying stock to bring lawsuits, most states require the plaintiff to have been a shareholder at the time of the wrongdoing.[63]

Derivative suits strip away the power of the board to decide whether the corporation will bring a lawsuit. They also expose the corporation to expense. For example, if the directors prevail, or even settle, the corporation may end up paying the directors' considerable attorney fees.[64] For this reason, a key screening device imposed upon derivative suits is the rule requiring that the plaintiff plead with particularity either a reason why the court should ignore the directors' rejection of the plaintiff's demand that they take action to remedy the breach,[65] or an acceptable excuse for not making such a demand.[66] In most jurisdictions, an acceptable excuse is that demand would be futile, essentially because we know already that the court will ignore the directors' rejection of a demand.[67] As a first approximation, the plaintiff accomplishes this by pleading that most of the directors have breached their duty, or are under the control of a party (such as a

59. *See, e.g.*, Schumacher v. Schumacher, 469 N.W.2d 793 (N.D. 1991) (allowing shareholder to sue in own right for damage to a closely held corporation).

60. *E.g.*, Sax v. World Wide Press, Inc., 809 F.2d 610 (9th Cir. 1987).

61. *E.g.*, Model Business Corp. Act § 7.41.

62. *E.g.*, Lewis v. Curtis, 671 F.2d 779 (3d Cir. 1982).

63. *E.g.*, Model Business Corp. Act § 7.41(a).

64. *E.g.*, Model Business Corp. Act §§ 8.51, 8.52.

65. *E.g.*, Model Business Corp. Act § 7.44(c).

66. *E.g.*, Fed. R. Civ. P. 23.1.

67. *E.g.*, Marx v. Akers, 88 N.Y.2d 189, 644 N.Y.S.2d 121, 666 N.E.2d 1034 (1996).

controlling shareholder) who has breached a duty.[68] Normal pleading rules in the United States could allow the plaintiff to accomplish this goal with conclusory statements, which would render the demand rule toothless. The bite in the rule comes from the requirement that the plaintiff plead with particularity—meaning the plaintiff must make detailed allegations of wrongdoing against most of the board members or detailed allegations that establish control by the wrongdoer over most of the directors.[69] In essence, the rule serves as a mechanism to test whether there are specific facts to support the plaintiff's claim before the corporation is put the expense of discovery (through which, however, the plaintiff might learn of such facts).

Under the demand rule, the court may excuse demand even though the complaint does not implicate every member of the board (perhaps because some members joined after the challenged transaction occurred). Corporations have responded by creating so-called special litigation committees consisting of non-defendant directors to whom the board delegates the power to decide if the corporation should pursue the lawsuit against the majority of directors. Courts have differed in dealing with motions by these committees seeking to dismiss derivative suits. Some have given the committee the benefit of the business judgment rule.[70] Others, led by Delaware,[71] have used this as an occasion for the court to determine whether the suit is in the corporation's interest. One state has rejected the whole idea of directors, precluded from deciding if the corporation should sue, nevertheless having the power to pick the persons to make this decision.[72]

Because derivative suit plaintiffs often own only a few shares, there is a great potential for collusive settlements; which is ameliorated, but not eliminated, by the requirement that the court approve any settlement.[73] Otherwise, the motive for shareholders with few shares bringing suit lies in the prospect for attorneys fees, which the court will award if there is a recovery (even a non-monetary recovery) for the corporation.[74] In essence, the system is one of attorneys acting as bounty hunters to police corporate directors.

Id.

69. *E.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

70. *E.g.*, Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).

71. *E.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

72. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983).

73. *E.g.*, Fed. R. Civ. P. 23.1.

74. *E.g.*, Bosch v. Meeker Coop. Light & Power Ass'n, 257 Minn 362, 101 N.W.2d 423 (1960).