1-1-1989

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The Duty of Care of Corporate Directors and officers, 51 U. Pitt. L. Rev. 945 (1989)

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THE DUTY OF CARE OF CORPORATE DIRECTORS AND OFFICERS†

Melvin A. Eisenberg*

Corporate directors and officers are under three general legal duties: the duty to act carefully, the duty to act loyally, and the duty to act lawfully. The subject of this Article is the first of those duties, generally known as the duty of care.

I. BACKGROUND PRINCIPLES

The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence. All law builds on moral, policy, and experiential propositions. The law of negligence is no exception. The moral proposition that underlies the law of negligence is that if a person assumes a role whose performance involves the risk of injury to others, he is under a moral duty to perform that role carefully. So, for example, one who

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This Article is based on the Mellon Lecture, which I delivered at the University of Pittsburgh School of Law in 1989. Given the original lecture format, I have not attempted to systematically cite the primary or secondary literature on the duty of care. Important recent articles that have illuminated my analysis include Arsh & Hinsey, Codified Standard—Same Harbor but Charted Channel—A Response, 35 BUS. LAW. July 1980 at ix; Burgman & Cox, Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the Trans Union Case, 11 J. CORP. LAW 311 (1986); Cohn, Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. REV. 591 (1983); Dyson, The Director’s Liability for Negligence, 40 IND. L.J. 341 (1965); Manning, The Business Judgment Rule and the Director’s Duty of Attention: Time For Reality, 39 BUS. LAW. 1477 (1984); Sorensen, Discretion and its Limits—An Analytical Framework For Understanding and Applying the Duty of Care to Corporate Directors (and Others), 60 WASH. U.L.Q. 553 (1988); and Veasey & Manning, Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared With Delaware Law, 35 BUS. LAW. 919 (1980).

I am Chief Reporter of the American Law Institute’s Principles of Corporate Governance, Part IV of which concerns the duty of care. The views expressed here, however, are my own, and are not intended as a gloss or interpretation of Part IV, whose formulations differ in some respects from those set out in this Article.

I thank Jesse Choper, John Fleming, Ron Gilson, Harvey Goldschmid, Howard Latin, and Marshall Small for their extremely helpful comments on earlier drafts, and Susan Klein for her excellent research assistance.

1. In some cases, one who assumes a role may be under an obligation to take steps to affirmatively reduce the risk of injury, so that even an omission may be wrongful.
assumes the role of driver is under a moral duty to drive carefully; one who assumes the role of doctor is under a moral duty to practice medicine carefully; one who assumes the role of judge is under a moral duty to judge carefully. The moral duty to perform a role carefully does not require that one act so as not to create any risk of injury to others. Any action involves a risk of injury to others. Although a person who sets out to drive, practice medicine, or judge may cause an injury that would not have occurred if he stayed home, that alone is not enough to assign moral blame. To assign moral blame, it must be the case that the person has not merely caused an injury, but has acted in a manner that involved an unreasonably great risk of causing an injury, as he knew or in the reasonable exercise of his abilities should have known.

On this foundation of moral blame, the law of negligence has erected a structure of legal blame or liability. The structure of legal blame under the law of negligence generally parallels the structure of moral blame, but differs in two critical respects.\(^2\)

First, for reasons of policy or administrability a person who has acted in a way that is morally blameworthy may nevertheless be fully or partially immune from liability under the law of negligence. So, for example, for reasons of policy judges are immunized from liability for injuries caused through carelessness in their judicial roles, even though the carelessness is morally blameworthy:

> Because government officials are engaged by definition in governing, their decisions will often have adverse effects on other persons. When officials are threatened with personal liability for acts taken pursuant to their official duties, they may well be induced to act with an excess of caution or otherwise to skew their decisions in ways that result in less than full fidelity to the objective and independent criteria that ought to guide their conduct . . . .

> . . . If judges were personally liable for erroneous decisions, the resulting avalanche of suits, most of them frivolous but vexatious, would provide powerful incentives for judges to avoid rendering decisions likely to provoke such suits. . . . The resulting timidity would be hard to detect or control, and it would manifestly detract from independent and impartial adjudication.\(^3\)

Second, for reasons of policy or administrability a person who is not morally blameworthy may nevertheless be held liable under the law of negligence. Moral judgments of a person's conduct are typically

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based on the internal springs that seem to drive that conduct. However, the standard that the community demands under the law of negligence is "an objective and external one, rather than that of the individual judgment, good or bad, of the particular individual." This principle "enables the triers of fact who are to decide whether the actor's conduct is such as to subject him to liability . . . to look to a community standard rather than an individual one." So, for example, in determining whether an individual in a given role has conducted himself in a manner that leads to liability under the law of negligence, the individual is normally judged not according to his own abilities, but according to the conduct that could be expected from a reasonable person—or, as it is sometimes put, from a person of ordinary prudence—in that role.

The imposition of liability where there is no moral blame is exemplified by the treatment of an individual who suffers under a mental or emotional disability, such as overexcitability, a lack of intelligence, or a lack of capacity for measured judgment. An individual who suffers under such a disability will be liable if he causes an injury by conduct that does not conform to the standard of a reasonable person, even though he was doing his best given his mental and emotional abilities—that is, even though, given his mental and emotional abilities, he neither knew nor should have known that he was creating an unreasonable risk of harm. Among the justifications for holding individuals "responsible according to a standard they cannot meet" are the administrative difficulty of distinguishing between an incapacity to exercise care and a failure to exercise care, and the policy judgment that, in the end, the objective of compensating the injured is more important than the objective of running a purely fault-based system.

Professionals, and agents in general, are subject to the same moral

4. RESTATEMENT (SECOND) OF TORTS § 283 comment b (1965).
5. Id. comment c.
6. Id. §§ 282, 283 & comment c to § 283. A person who has more-than-usual skill for a given role is also normally obliged to exercise that skill.
7. Id. § 283B. Of course, it can be argued that such an individual is morally at fault for simply acting at all, because he should have known he lacked the capability for acting carefully. Although this may be a fair characterization of some such cases, it seems that for the most part in these cases liability is imposed "even in the absence of moral blame." W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS 177 (4th ed. 1984) [hereinafter PROSSER & KEETON].
Different rules apply to physical incapacities and to children.
8. PROSSER & KEETON, supra note 7, at 177.
9. See 3 F. HARPER, F. JAMES & O. GRAY, supra note 2, at 392-93 (2d ed. 1986); RESTATEMENT (SECOND) OF TORTS § 283B comment b (1965).
duty to exercise care in the performance of their roles as is every other member of society. Professionals, and agents in general, are also subject to liability for failure to exercise care, under the law of malpractice and the law of agency. For example, the Restatement of Agency provides that an agent is "subject to a duty . . . to act with standard care."\(^\text{10}\) The comment adds that this rule is applicable not only to a servant doing manual work, but to an agent who is normally given discretion as to the manner in which he performs his duty. In the use of this discretion he is under a duty to act competently and carefully and for a mistake in judgment resulting from a failure to have the standard knowledge or to use the standard care, he is subject to liability to the principal.\(^\text{11}\)

A moral obligation to exercise care in the performance of one's role is also imposed on corporate directors and officers. This moral obligation is an aggregate comprised of four relatively distinct duties, each of which requires separate analysis. These are:

1. The duty of directors to reasonably monitor or oversee the conduct of the corporation's business, and, as a corollary, to take reasonable steps to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques.
2. The duty of inquiry—that is, the duty to follow up reasonably on information that has been acquired and should raise cause for concern.
3. The duty to employ a reasonable decisionmaking process.
4. The duty to make reasonable decisions.

The liability imposed on corporate directors and officers by law is congruent with, but not identical to, these four moral duties. The general legal principle, expressed in section 4.01(a) of the American Law Institute's Principles of Corporate Governance,\(^\text{12}\) is that a director or officer must act in a manner that he 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. A counter-

\(^{10}\) Restatement (Second) of Agency § 379(a) (1958).

\(^{11}\) Id. comment c.

\(^{12}\) A.L.I., Principles of Corporate Governance § 4.01 (Tent. Draft No. 4, 1985).
part of this principle is to be found in most statutes. The translation of that general principle into specific legal rules involves a number of difficult issues. One source of these difficulties is that what constitutes reasonable care must always be colored by context, so that, for example, what constitutes reasonable care in the context of highly complex and inherently risky group decisionmaking will differ from what constitutes reasonable care in such paradigm contexts as automobile accidents. Another source of these difficulties is that special considerations of policy and fairness apply to decisionmaking by directors and officers. As I will show, broadly speaking the components of a director's or officer's liability resemble the components of the moral duty, except that for reasons of policy and fairness, in certain cases the law provides a partial immunity to directors and officers who have made decisions that could fairly be deemed unreasonable.

II. FUNCTIONS, KNOWLEDGE, COMPETENCE, AND SKILL

An analysis of the duty of care of directors and officers must begin with the functions that directors and officers are obliged to perform, and the knowledge, competence, and skill they are expected to have.

A. Functions

Until fifteen or twenty years ago, the received legal model of the corporation contemplated that the board of directors managed the corporation's business and made business policy; the officers acted as agents of the board and executed its decisions; and the shareholders elected the board and decided major corporate actions. It is now well understood that the received model did not reflect business reality. Many boards meet no more than six times a year, and few meet more than twelve times a year. Board meetings usually last only a few hours, time spent preparing for meetings is roughly comparable to time spent in meetings, and committee time is unlikely to exceed board time. By reason of time constraints alone, therefore, the typical board could not possibly "manage" the business of a large publicly held corporation in the normal sense of that term. Such businesses are far too complex to be managed by persons who put in the equivalent of at most ten or fifteen working days a year.

15. Id. at 141-42.
The same imperative precludes the board from making business policy. In a complex organization concerned with complex choices, policy cannot be developed on a part-time basis. Furthermore, although an opportunity to consider relevant information is obviously essential to meaningful decisionmaking, the amount, quality, and structure of the information that reaches the board is largely within the control of the corporation's executives. In short, it is the executives, and not the board, who normally manage the business and set business policy.

This reality is reflected in sections 3.01 and 3.02 of the ALI's *Principles of Corporate Governance*. Under section 3.01, the management of the business of a publicly held corporation should be conducted by or under the supervision of such senior executives as may be designated by (and subject to the powers of) the board of directors. Under section 3.02, the major functions of the board are to review and approve major corporate plans and actions (such as capital and operating budgets and the creation of significant long-term debt); to elect, evaluate, and, where appropriate, dismiss the principal senior executives; and to oversee the conduct of the corporation's business and the performance of its managers.

B. Knowledge, Competence, and Skill

What degree of knowledge, competence, and skill is expected of a director or officer in performing his functions? Again, it is useful to begin with background principles.

Under the law of negligence, an actor is treated as if he has at least such knowledge as a reasonable person would have, and, if his knowledge exceeds that of a reasonable person, such knowledge as he actually has. More specifically, an actor is treated as if he has community knowledge concerning the qualities, capacities, and characteristics of persons and forces even if in fact he lacks that knowledge. As the *Restatement of Torts* puts it, for liability purposes a person is treated as if he knows the speed at which cars travel, even if he was

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16. *Id.* at 143-44.
17. *Id.* at 140.
20. *Id.* § 290.
brought up on a small island and does not know the speed at which cars travel.  

The law of malpractice speaks to the more particular issues of competence and skill. Competence consists of the knowledge and aptitude to use care in performing an action. Skill is that special form of competence that is the result of acquired learning and aptitude developed by special training and experience in a trade or profession.  

Under the law of malpractice, professionals are required to have and use the skill employed by members of the profession in good training, and will be liable if harm results because they lack that skill.

The law of agency also speaks to the issue of skill. Under the Restatement of Agency, an agent "is subject to a duty to act... with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has."  

Unlike other professionals, directors, acting in that capacity, are usually generalists. That does not mean, however, that they need have no special knowledge, competence, or skill. In Francis v. United Jersey Bank, the court said:

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged... If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act."  

In contrast to directors, officers usually are expected to have special competence and skill—the competence and skill of managers, and, if they hold a specialized position (such as a finance post), the competence and skill necessary for that position.

III. THE DUTY TO MONITOR

With this background, I shall now review the specific duties that comprise the legal duty of care. The first of these is the duty of directors to reasonably monitor or oversee the conduct of the corporation's business, and, as a corollary, to take reasonable steps to keep abreast of

21. Id. comment a.
23. Id.
the information that flows to the board as a result of monitoring procedures and techniques. Typically, the duty to monitor is satisfied not, or not primarily, by direct observation, but by installing or reviewing the adequacy of procedures or techniques by which salient information concerning the conduct of a corporation's business will flow to the board, or to reliable executives or third-party professionals acting on the corporation's behalf and subject to the ultimate responsibility of the board. Thus the Business Roundtable has stated that one of the primary functions of the board is to "[r]eview the adequacy of systems to comply with all applicable laws [and] regulations." More generally, as Bayless Manning has stated:

[N]o board can deny the existence of a built-in paramount responsibility with regard to what may be called the organic or structural integrity of the company. This organic integrity is essentially made up of two elements. A company must have a functioning management in place and operating at all times. A board can itself see that this is done. And a company must have an internal information system in place that is generally suitable for an enterprise of the company's character to keep the management informed about what is going on and particularly to provide the accounting data on which to base financial statements. The board cannot design, install, operate, or monitor the operation of such systems; but the board can press for their installation and call for periodic assurances that they are in place. As to these two organic elements of the enterprise, the directors may not wait for the management to bring issues to their attention. The responsibility of the board in these two key regards is inherent and ongoing; it is up to the board to take the initiative to keep itself informed about them . . . .

A leading modern case concerning the duty to monitor is Francis v. United Jersey Bank, which involved a reinsurance broker. Insurers often seek to reduce their exposure under a class of policies, or a particular policy, by finding other insurers to take over part of the class or policy. Reinsurance involves contracts under which Insurer B agrees to indemnify Insurer A for losses sustained under policies that Insurer A has issued. Insurer A, which seeks B's participation, is known as the ceding company. Insurer B, which assumes an obligation under A's policies, is known as the reinsurer. A reinsurance broker arranges the contract between the ceding company and the reinsurer. In most cases, the ceding company and the reinsurer do not communicate with each other. When a premium is due to a reinsurer, the ceding company pays the

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premiums to the broker for transmission to the reinsurer minus the broker’s fee. When a loss occurs, the reinsurer pays its share of the loss to the broker for transmission to the ceding company. Industry practice calls for the broker to segregate these premium and loss transmission payments from its general accounts.

Pritchard & Baird was a corporation engaged in business as a reinsurance broker. Pritchard Sr. was its principal founder. In 1960, Pritchard Sr. began to gradually relinquish control to his son, Charles. In 1969, Charles became president, and his brother William became executive vice-president. From that time forward, Charles dominated the corporation’s management. Pritchard Sr. died in 1973. After his death, his widow, Lillian Pritchard, owned 48% of the corporation’s stock, and the board consisted of Charles, William, and Mrs. Pritchard.

Mrs. Pritchard was bedridden for a six-month period, and started to drink heavily. She was not active in the business of Pritchard & Baird, and knew virtually nothing of its corporate affairs. She visited the corporate offices on only one occasion, and never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance, and made no effort to ensure that the policies and practices of Pritchard & Baird complied with industry custom or relevant law.

Contrary to the industry practice, Pritchard & Baird commingled premium and loss transmission payments with its own funds in a single account. Starting in 1970, Charles and William began to siphon increasing sums from this account. The payments were denominated “loans,” but actually constituted a misappropriation of money that belonged to the corporation’s clients. (Charles and William were able to misappropriate these funds because both ceding and reinsuring companies allowed a grace period of thirty to ninety days before premium or loss payments were due.) As of January 1970, the “loans” to Charles and William were over $400,000. By October 1975, the “loans” had metastasized to over $12 million. That year, the corporation went into bankruptcy.

The trustee sued Mrs. Pritchard to recover the amount of the loans. The court held Mrs. Pritchard liable for the amount of the misapplied funds, based on her failure to oversee the corporation’s affairs.

Directors are under a continuing obligation to keep informed about the activities of the corporation . . . .

Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies . . . .

While directors are not required to audit corporate books, they should main-
tain familiarity with the financial status of the corporation by a regular review of financial statements 

As a director of a substantial reinsurance brokerage corporation ... Mrs. Pritchard should have obtained and read the annual statements of financial condition of Pritchard & Baird 

From those statements, she should have realized that, as of January 31, 1970, her sons were withdrawing substantial trust funds under the guise of "Shareholder's Loans." ... Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. Thus, if Mrs. Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to stanch the flow of blood.

In summary, Mrs. Pritchard was charged with the obligation of basic knowledge and supervision of the business of Pritchard & Baird. Under the circumstances, this obligation included reading and understanding financial statements, and making reasonable attempts at detection and prevention of the illegal conduct of other officers and directors. She had a duty to protect the clients of Pritchard & Baird against policies and practices that would result in the misappropriation of money they had entrusted to the corporation. She breached that duty.

The duty to monitor does not require a director to acquire information on all aspects of a corporation's activities. As a practical matter, this would be infeasible. It would also be undesirable, because the benefits of acquiring information on some activities might not be worth the costs. Furthermore, the resulting overload might well inhibit the director's understanding of significant information. Accordingly, it is consistent with the monitoring obligation to give little or no attention to a given matter, depending on the status and scope of the matter, the reasonableness of delegations concerning the matter, and the director's judgment on such issues as the ripeness of the matter and its practical importance. As stated in section 4.01(b) of the Principles of Corporate Governance, "[s]ubject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate ... 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. ..."

30. As the first clause of § 4.01(b) suggests, directors cannot delegate away all of their monitoring or oversight obligations. The board must retain ultimate responsibility for overseeing the conduct of the corporation's business. See, e.g., A.L.I., PRINCIPLES OF CORPORATE GOVERN-
Furthermore, an informed decision on the manner in which the monitoring obligation is performed may not give rise to liability even though the decision works out badly. Such a decision may involve a general identification of the criteria concerning what oversight matters should be placed on the board's agenda, or a specific decision to adopt or not adopt a particular type of monitoring system or to shape a given system in a certain way. For example, the board may marshall relevant information, appraise the risks, and then make a deliberate decision not to install an antitrust-compliance program or a computer-security program. Similarly, the board may conclude that the effectiveness of a particular program need only be reviewed once every two years, or may delegate to others the authority to design and oversee the effectiveness of a particular program. If a delegation is reasonable, a failure in its execution by corporate officers or agents is not a violation of the board's monitoring obligation.31 More generally, if a deliberate decision

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31. See A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a)(1)-(2), illustrations 1, 2 (Tent. Draft No. 4, 1985):

1. Last year X Corporation, which had annual sales of $900,000,000 and a wide distribution system for its consumer products, was fined $1 million for horizontal price-fixing, a criminal violation of the Sherman Act. It also had to settle a number of civil antitrust actions by paying an aggregate of $16.8 million. The directors of X Corporation have never been concerned with the existence of an antitrust compliance program, and X Corporation still has no company statement on antitrust policy and no compliance program. A new horizontal price-fixing violation has just occurred. It is clear, however, that the directors of X Corporation had no knowledge of the new antitrust violation. The directors of X Corporation may well have violated their duty of care. The recent antitrust violations, the size of X Corporation, and its wide distribution system should have made compliance with the antitrust laws a particularly prominent concern. Unless other facts were present, such as the delegation of antitrust law compliance functions to the general counsel and proper reliance on him . . . the failure of the directors of X Corporation to be reasonably concerned with the existence of an antitrust compliance program would constitute a breach of the directors' duty of care.

2. The facts being otherwise as stated in Illustration 1, after the $1 million fine was paid, X Corporation did in fact install an antitrust compliance program which required X's local staff attorneys to refer all antitrust circumstances—and report all suspicious circumstances—to a designated staff attorney at company headquarters. An attorney in one regional office has, however, failed to report questionable conduct that may constitute a per se antitrust violation. X's directors cannot be subjected to liability for an isolated breakdown in the compliance program. No violation of § 4.01(a) has occurred.
by the board on whether or how to monitor a given activity satisfies the conditions of the business-judgment rule, the board may be insulated from liability even though the decision was not a reasonable one.  

IV. THE DUTY OF INQUIRY

A second basic duty of care, sometimes referred to as the duty of inquiry, is to follow up reasonably on information that has been acquired and should raise cause for concern.

[N]o director or group of directors may choose to ignore credible signals of serious trouble in the company. If a director is informed through a credible source that there is reason to believe that the chief financial officer is a compulsive gambler, the director must take an initiative; he may not sit back and wait for the management to bring the matter to the board's attention. There will usually be a wide range of possible actions which a director could reasonably take to pursue such a matter and thereby fulfill his obligation as a director; but he cannot simply do nothing. Execution of this responsibility of a director will be episodic and, typically, infrequent, but the responsibility itself is ongoing and present every day.

The duty of inquiry may be triggered by information acquired through the duty to monitor, but it may also be triggered by information that reaches a director or officer in other ways—even adventitiously. A leading case in this area is Bates v. Dresser, decided by the United States Supreme Court in 1920 in an opinion by Justice Holmes. This case arose out of embezzlements, by a man named Coleman, of a small bank in Cambridge. The bank had a capital of $100,000 and average deposits of around $300,000. Dresser was both its president and a large stockholder. He also had an inactive deposit of $35,000 to $50,000. Coleman had joined the bank as messenger in 1903, and was soon promoted to bookkeeper. In 1904 and 1905 there were small shortages in the accounts of three successive tellers (then a position of some importance), and in October 1905 the then teller, Cutting, was asked by Dresser to resign on that ground. Before he resigned, Cutting told Dresser that someone had stolen the money, and that if he was allowed to stay he would catch the thief, but Dresser thought there was nothing wrong.

Coleman was then appointed teller, and used that position to embezzle the bank's accounts. By May 1907, he had embezzled $17,000.

32. See infra Part V.
33. Manning, supra note 27, at 1484-85.
34. 251 U.S. 524 (1920).
By November 1907, he had embezzled just over $30,000. By the end of 1908, he had embezzled almost $50,000. In 1909, Coleman's activity began to increase, and by June his total embezzlements were over $83,000. In each of October, November, and December, he took more than $45,000. By February 1910, he had taken over $300,000. Not surprisingly, the affair ended in bankruptcy, and the trustee brought suit against Dresser and the directors.

Coleman's technique, essentially, turned on understating deposits (that is, liabilities), rather than the more usual embezzlement technique of overstating assets. During this time, the amount of monthly deposits had, accordingly, seemed to decline noticeably. The directors had considered the matter in September 1909, but thought the drop was due in part to the springing up of rivals. Neither an examination by a bank examiner in December 1909 nor previous semi-annual examinations by bank examiners disclosed anything wrong.

The Court held that the outside directors had not violated their duty of care, because (at least in the Court's view) they had not violated their duty to monitor, and the facts that came to their attention did not raise a duty of inquiry:

[The directors'] confidence seemed warranted by the semi-annual examinations by the government examiner, and they were encouraged in their belief that all was well by the president, whose responsibility, as executive officer; interest, as large shareholder and depositor; and knowledge, from long daily presence in the bank, were greater than theirs.\(^{35}\)

In contrast, the Court held that Dresser, the president, was liable, partly because he did not monitor properly, and partly because facts that the other directors did not know, but he did, should have caused him to make inquiry:

The position of the president is different. Practically he was the master of the situation. He was daily at the bank for hours, he had the deposit ledger in his hands at times and might have had it at any time. He had hints and warnings . . . that should not be magnified unduly, but still that taken with . . . the unexplained shortages, the suggestion of the teller, Cutting, in 1905, and the final seeming rapid decline in deposits, would have induced reliance but for an invincible repose upon the \textit{status quo}. In 1908 one Fillmore learned that a package containing $150 left with the bank for safe keeping was not to be found, told Dresser of the loss, wrote to him that he could but conclude that the package had been destroyed or removed by someone connected with the bank, and in later conversation said that it was evident that there was a thief in the bank. He added

\(^{35}\) \textit{Id.} at 530.
that he would advise the president to look after Coleman, that he believed he was living at a pretty fast pace, and that he had pretty good authority for thinking he was supporting a woman. In the same year or before, Coleman, whose pay was never more than $12 a week, set up an automobile, as was known to Dresser. . . . There was also some evidence of notice to Dresser that Coleman was dealing in copper stocks. . . . However little warnings may have pointed to the specific facts, had they been accepted they would have led to an examination of the depositors' ledger, a discovery of past and a prevention of future thefts.\(^36\)

In short, directors and officers are under a duty to use reasonable care in following up on information that has been acquired either through the performance of the monitoring function or otherwise, and which should raise cause for concern.

V. CARE IN MAKING DECISIONS

The last two components of the duty of care involve care in performing the decisionmaking function. As in many other areas of law, the rules governing this area have a procedural and a substantive element. The procedural element concerns the process of decisionmaking, and more specifically, the manner in which a director or officer should inform himself before making a decision. The substantive element concerns the quality of the decision itself.

A. The Procedural Element

The procedural element of the law governing decisionmaking by directors and officers is based on the general principle that directors and officers must use reasonable care.\(^37\) Specifically, directors must use reasonable care in informing themselves, or to put it differently, must properly inform themselves, concerning a proposed action before making a decision. What is reasonable care in informing oneself in any given case depends on a great variety of considerations, such as the scale of the decision, the time available to make it, the cost involved, and the confidence the director or officer can reasonably have in analyses and recommendations by subordinates. The inquiry need not be exhaustive. Business decisions must sometimes be made with considerable haste. The inquiry that might reasonably be required if weeks were available might not be required if the risk of forgoing a profitable

\(^36\) Id. at 530-31.

\(^37\) Some states purport to use a "gross negligence" test rather than a simple negligence test. See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). How much difference there is between these tests is open to question. In Smith v. Van Gorkom itself, many have questioned whether even simple negligence was shown.
transaction compelled directors to act in a matter of hours. The time realistically available may compel risk-taking, which may include not only the risk related to the economic consequences of a proposed transaction, but also the risk of not having all relevant facts concerning the transaction before entering into it.\textsuperscript{38}

\section*{B. The Substantive Element}

In contrast to the procedural element of the law governing decisionmaking by directors and officers, which is based on the general principle of reasonableness, the substantive element, which concerns the quality of decisions, is based on a special protective rule—the business-judgment rule. That rule has four parts, three of which are conditions for its application.

First, the business-judgment rule is applicable only if a decision has been made.\textsuperscript{39} So, for example, a simple failure by the director to reasonably inform himself concerning a proposed action does not qualify for the protection of the rule.

Second, the business-judgment rule is applicable only if the director or officer is not financially interested in the subject matter of a decision.\textsuperscript{40} So, for example, the rule is inapplicable to a decision by a director to approve a purchase by the corporation of his own property.

Third, the procedural element of the law governing decisionmaking by directors and officers must have been satisfied, that is, the business-judgment rule is applicable only if the director or officer has reasonably informed himself concerning the decision.\textsuperscript{41}

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\bibitem{38} A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01, §§ 4.01(a)(1)-(a)(2), at 46-47 (Tent. Draft No. 4, 1985).
\bibitem{39} Id. § 4.01(c) comment c.
\bibitem{40} Id. § 4.01(c) comment d.
\bibitem{41} Section 4.01(c)(2) of the ALI Principles of Corporate Governance makes it a condition to the applicability of the business judgment rule that the officer or director "is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances." The comment adds:

The great weight of case law and commentator authority supports the proposition that an informed decision (made, for example, on the basis of explanatory information presented to the board) is a prerequisite to the legal insulation afforded by the business judgment rule. In a much quoted statement, the court in Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944), observed: "When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised." See Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (citing the Woodruff statement with approval). Professor Ballantine concluded: "It is presupposed in this 'business judgment rule' that reasonable diligence and care have been exercised." H. BALLANTINE, LAW OF CORPORATIONS § 63a at 161 (rev. ed. 1946); see, e.g.,

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We come now to the heart of the business-judgment rule. If a director or officer makes a decision, and is disinterested and has reasonably informed himself, the quality of the decision will not be reviewed under the normal standard of reasonableness, but instead will be subject to only exceptionally limited review. The precise standard of review is stated in various ways. Provisionally, I shall employ the standard of review adopted in section 4.01 of the ALI's *Principles of Corporate Governance*: The director or officer will not be liable if he rationally believed that his decision was in the best interest of the corporation.\(^2\) To see how exceptional this standard is, we need only think about the judgments we make in everyday life. It is common to characterize the conduct of others as not reasonable, but it is very uncommon to characterize the conduct of others as not rational.

There is, it is true, a rule in negligence that sounds very much like the business-judgment rule. It is often said, especially in malpractice cases, that "honest errors of judgment" will not give rise to liability. For example, in *Haase v. Garfinkel\(^4\) Haase believed he was having a heart attack, and saw Dr. Garfinkel, a heart specialist. Dr. Garfinkel ordered Haase hospitalized, had him kept under observation, and ran EKGs and a blood-chemistry test. Dr. Garfinkel concluded that Haase was suffering from coronary-artery insufficiency, rather than from a heart attack, and therefore did not prescribe anticoagulant drugs. The day after Haase was discharged from the hospital, however, he had a massive heart attack and died. His widow sued Dr. Garfinkel, and the case was submitted to the jury on the theory that Dr. Garfinkel had been negligent in failing to prescribe anticoagulant drugs. The evidence showed that although anticoagulant drugs were often used in comparable situations, there was a strong divergence of opinion in the medical

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Joy v. North, 692 F.2d 880, 886, 896 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 111 (1979) (The business judgment rule should not be available to directors who do "not exercise due care to ascertain the relevant and available facts before voting").

The informed decision prerequisite in § 4.01(c)(2) focuses on the preparedness of a director or officer in making a business decision as opposed to the quality of a decision itself. Fundamental to an understanding of the standard set forth in § 4.01(c) is the recognition that the extent of the information required is that which the director or officer "reasonably believes to be appropriate under the circumstances." Here, as elsewhere in Part IV, the term "reasonably believes" has both an objective and a subjective content.

*Id.* § 4.01(c) comment e.


43. 418 S.W.2d 108 (Mo. 1967).
profession on the advisability of these drugs. Many respectable authorities held the view that the possible side effects of anticoagulants ruled out their use for many patients, and Dr. Garfinkel testified that he deemed further tests and studies necessary before using these drugs. On these facts, the Missouri Supreme Court affirmed a directed verdict for Dr. Garfinkel under the honest-error-of-judgment rule:

Even if defendant had been mistaken about . . . [the use of anticoagulants,] in Mr. Haase's case he was entitled to a wide range in the exercise of his judgment and discretion and could not be found guilty of negligence "unless it be shown that the course pursued was clearly against the course recognized as correct by the profession generally. As long as there is room for an honest difference of opinion among competent physicians, a physician who uses his own best judgment cannot be convicted of negligence, even though it may afterward develop that he was mistaken." . . . If in retrospect . . . it might appear that a mistake was made, plaintiff still fails to make a case for lack of evidence from which a jury might conclude that defendant did not exercise his best judgment in deciding against the immediate administration of anticoagulant drugs."

Similarly, in Bryant v. Rankin the Eighth Circuit held that an error in diagnosis will not support a verdict for damages unless there is evidence of lack of care or skill in making the examination or forming the physician's judgment. In Rainer v. Community Memorial Hospital, the California Court of Appeal approved a jury instruction that a physician is not negligent if in exercising his best judgment he selects one of the methods recognized by practitioners of good standing, which later turns out to be a wrong selection. In Dickens v. Everhart, the North Carolina court said a qualified physician, who forms his judgment after a careful and proper examination or investigation of the particular patient's condition, is not an insurer of his diagnosis or of the success of his treatment and is not liable for an honest error of judgment.

On the surface, the business-judgment rule might seem to be simply a special case of the honest-error-of-judgment rule. In fact, however, it is not. Although the malpractice cases usually do not explain precisely what is meant by the honest-error-of-judgment rule, it is clear that the purpose of the rule is to distinguish between bad decisions and decisions that turn out badly. In paradigm negligence cases involving relatively simple decisions, such as automobile accidents, there is often

44. Id. at 114.
45. 468 F.2d 510 (8th Cir. 1972).
47. 284 N.C. 95, 199 S.E.2d 440 (1973).
little difference between these two concepts, because typically only one reasonable decision could have been made. In such cases, decisions that turn out badly almost inevitably turn out to be bad decisions. In contrast, in cases involving complex judgments of a sort that are often necessarily made on the basis of incomplete information and in the face of obvious risks either way, there are typically a range of decisions that are reasonable. A surgeon who discovers a complication in mid-operation may have to choose between two techniques for dealing with the complication, which involve comparable but different risks. He chooses one of these techniques, and the risk materializes. The decision turned out badly, but it was not for that reason a bad decision.

The honest-error-of-judgment rule covers just this kind of decision—a decision that was reasonable when made, but turns out to be in "error" in the very restricted sense that if the decisionmaker had it to do all over again he would make a different decision. Indeed, if the courts are correct in their evaluations in these cases there is really no error at all. A decisionmaker faced with uncertainty knows that he must make a judgment concerning the relevant probability distribution, and must act on that judgment. If the decisionmaker makes a reasonable judgment about the shape of the distribution, and the outcome falls on the unlucky tail, the decisionmaker has not made any error in the normal sense of that term, because in any normal probability distribution some outcomes must inevitably fall on the unlucky tail.

The idea that lies behind the honest-error-of-judgment rule, that where more than one decision would be reasonable a bad result does not mean there was a bad decision, is also undoubtedly one of the ideas that lie behind the business-judgment rule. Nevertheless, the business-judgment rule differs qualitatively from the honest-error-of-judgment rule. With limited exceptions, malpractice cases require not only that a physician be properly informed before making his decision, but that the decision itself be rendered with care. To put this differently, under the law of medical malpractice a physician is held to a standard of ordinary care in arriving at his diagnosis and prescribing treatment. It is true that the diagnosis and treatment will not give rise to liability just because they turn out badly. It is also true that the diagnosis and treatment will not give rise to liability even though many or even a majority of other doctors would have come to a different diagnosis or given a different treatment, if a respectable body of opinion supports the diagnosis and treatment actually rendered. That, however, is as far as medical malpractice cases normally go. If there is not a respectable body of
opinion supporting the physician's judgment, or if there is a lack of requisite skill or a lack of care in applying the requisite skill to formulate that judgment, the physician will be liable. Thus in *Dickens v. Everhart* the North Carolina court said that a qualified physician who forms his judgment after a careful and proper examination is not liable for an honest error in judgment, but added that a physician who undertakes to render professional services must possess the degree of professional knowledge and skill that others similarly situated ordinarily possess, and must exercise reasonable care and diligence in the application of his knowledge and skill to the patient's case. In *Hansenei v. United States*, the court held that a physician is required to possess and employ the knowledge and skill of a physician in a similar locality, and in employing such knowledge and skill he must exercise the care and judgment of a reasonable person. In *Larkin v. New York*, the court held that a physician who departs from accepted medical practice is normally subject to liability.

The business-judgment rule applicable to directors and officers goes much further than the honest-error-of-judgment rule of general tort law. Under the business-judgment rule, there is no liability even though a decision is unreasonable. But why should a much lower standard of care be set for reviewing the quality of decisions by corporate directors and officers than for reviewing the quality of decisions by almost anyone else—even other professionals?

The answer to this question involves considerations of both fairness and policy.

To begin with, the application of an ordinary standard of care to the quality of decisions by directors and officers might too often result in the unfair imposition of liability. It has already been shown that where a range of decisions is reasonable, it is often difficult to sort out decisions that turn out badly from bad decisions. Under an ordinary standard of care, factfinders might too often confuse the two concepts and unfairly impose liability on directors and officers for decisions that turned out badly but were not bad decisions.

It is true that the law of medical malpractice accepts this risk: despite the honest-error-of-judgment rule, physicians may be held lia-

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50. The similar-locality element of this test has now largely been abandoned in favor of a national standard.
51. 84 A.D.2d 438, 446 N.Y.S.2d 818 (1982).
ble for unreasonable lack of care in diagnosis and prescription. However, physicians often can defend the quality of their decisions by pointing to established protocols or accepted medical practice, and factfinders use such protocols and practices as objective benchmarks to test the quality of decisions. In contrast, because every business decision is unique, directors and officers can seldom shield the quality of their decisions by pointing to protocols or accepted practices, and factfinders will seldom have an objective benchmark to guide them. Furthermore, the law may be more willing to take the risk of erroneous imposition of liability in cases that characteristically involve injury to the person than in cases that typically involve only economic damages, which, moreover, are normally not catastrophic to any single individual.52

Moreover, the shareholders' own best interests may be best served by a very limited review of the quality of directors' and officers' decisions. It is often in the interests of shareholders that directors or officers make a more risky rather than a less risky decision, because the expected value of the more risky decision may be greater than the expected value of the less. For example, suppose that Corporation C has $100 million in assets. C's board must choose between Decision X and Decision Y. Each decision requires an investment of $1 million. Decision X has a 75% likelihood of succeeding. If the decision succeeds, C will gain $2 million. If it fails, C will lose its $1 million investment. Decision Y has a 90% chance of succeeding. If the decision succeeds, C will gain $1 million. If it fails, C will recover its investment. It is in the interest of C's shareholders that the board make Decision X, even though it is riskier, because the expected (risk-adjusted) value of decision X is $1.25 million while the expected value of decision Y is only $900,000. If, however, the board was concerned about liability for breaching the duty of care, it might choose Decision Y, because as a practical matter it is almost impossible for a plaintiff to win a duty of care action on the theory that a board should have taken greater risks than it did. A rule that imposes liability on a director or officer for unreasonable decisions might therefore have the perverse incentive effect of discouraging bold but desirable decisions.53

52. This factor may also explain why the law is willing to impose liability in the areas of product design and toxic torts, even though decisions on these issues are also complex and uncertain.

53. To some extent this may also be true of other areas, such as medical malpractice. However, the duty of care of directors and officers is not completely comparable to medical malprac-
This justification of the business-judgment rule also helps explain why different standards are applicable to the process of decisionmaking and the quality of decisions. The law should avoid discouraging directors or officers from making bold decisions, but it should not discourage directors or officers from doing their homework.

Directors . . . are free to govern; such governing often involves risk-taking entrepreneurial activity. This is not to say, however, that shareholders bargain for every risk. The thrust of . . . [Smith v. Van Gorkum54] is that inherent in the relationship between shareholders and directors is the assumption that the decisionmaking process will be an informed one: uninformed decisionmaking is not part of the bargain.55

Putting this point more broadly, a review of the quality of directors' and officers' decisions typically involves, among other things, a choice of what risks and risk-levels the corporation should undertake. For reasons that have been examined, a special rule properly applies to such reviews. In contrast, the general duty to monitor, the duty to make due inquiry, and the duty to reasonably inform oneself concerning a proposed decision typically do not involve a choice of what risks or risk-levels the corporation should undertake.

The next question is, just what standard should be applied to the substantive review of directors' or officers' decisions? There are two major types of formulation.

Under one type of formulation, embodied in section 4.01 of the ALI's Principles of Corporate Governance, the quality of directors' and officers' decisions is made subject only to a review for rationality or the like. Judge Friendly has described a requirement of rationality as "a minimal requirement of some basis in reason."56 Perhaps the most obvious type of a decision that lacks rationality is one that simply cannot be explained. For example, in Selheimer v. Manganese Corp. of America,57 the managers poured the corporation's funds into a single plant even though they knew the plant could not be operated profitably because of a lack of railroad siding, proper storage areas, and other

54. 488 A.2d 858 (Del. 1984).
factors. The court imposed liability on the ground that the defendants’ conduct “defies explanation; in fact, that defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures.”

Under a second, less common type of formulation, in form at least there is no review at all of the quality of a decision: the only issue beyond procedural care is whether the decision was made in good faith.

An argument for a pure good-faith rule is found in a recent opinion of Chancellor Allen in *In re RJR Nabisco, Inc. Shareholders Litigation.* Chancellor Allen there said:

> I can understand no legitimate basis whatsoever to impose damages (or enter an injunction) if truly disinterested directors have in fact acted in good faith and with due care on a question that falls within the directors’ power to manage the business and affairs of the corporation. To recognize in courts a residual power to review the substance of business decisions for “fairness” or “reasonableness” or “rationality” where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors.

Taken on its face, this language is unclear. If a decision is made with “due” or “appropriate” care, of course there is no ground for liability, at least if due or appropriate care refers to the quality of the decision as well as the decision-making process. What Allen really seems to mean by due or appropriate care, however, is procedural care—care in informing oneself. So interpreted, Allen’s argument is that there is “no legitimate basis whatsoever” for a review of the quality of the decision of a director or officer, and that for the courts to do so would be to arrogate the power of a role—that of director or officer—which they have not been assigned.

Allen here forgets, however, that the general principle of law is precisely that one who assumes a role whose performance involves a risk of injury to others is normally subject to liability if he fails to perform that role carefully, that is, in the way a reasonable person would have performed it, and that courts should review decisions to determine whether they meet that standard. A court that holds a director or officer liable for a decision that is not rational no more arrogates the function of director than a court that holds a doctor liable for an unreasonable decision arrogates the function of a doctor, or a court

58. *Id.* at 646.
60. *Id.* at 91,710 n.13 (citation omitted).
that holds a driver liable for an unreasonable decision arrogates the function of driver.

Allen also forgets that a review of the quality of the decisions of directors and officers is justified by the classic principle that courts of equity will enjoin a fiduciary from wasting the beneficiary's assets.

In short, the special feature of corporation law is not that the quality of decisions of directors and officers is subject to review, but that the review is only for a quality less demanding than reasonability, that is, the quality of rationality.

There is another possible defense of a pure good-faith standard. It could be argued that such a rule would conform the law more closely to morality, because it would impose liability only on those who act improperly. This argument, however, proves too much. For one thing, the argument is at odds with much or most of the law of torts, which seldom employs a pure-good-faith test. For another, a person who takes an action that he knew or should have known involves an unreasonably great risk of harm may be said to have acted improperly even if he acts in good faith. In this connection, it is important to bear in mind that the business-judgment rule is a standard of review, not a standard of conduct. Although the law immunizes directors and officers for liability for unreasonable decisions, it remains true that a director or officer who makes an unreasonable decision has acted improperly.

A pure good-faith standard would therefore depart too far, and unjustifiably, from the general principles of law applicable to private individuals who assume roles the performance of which involves the risk of injury to others. Such a standard would be subject to a further problem as well—the lack of clarity as to the meaning of good faith. One of the few areas where a definition of good faith is codified is in the Uniform Commercial Code, but even the Code lacks clarity on this point. Under Part I of the Code (General Provisions), good faith is defined as "honesty in fact in the conduct or transaction involved."61 Although this definition seems to be subjective, it may not be. For example, a person may be said to act honestly if he acts according to his own best lights, or a person may be said to act honestly only if he acts according to his own best lights and without transgressing the basic moral standards set by the society. Furthermore, under Part II of the Code (Sales), in the case of a merchant good faith is defined to mean

"honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."\textsuperscript{62}

The Code's definitions illustrate the ease with which a good-faith standard can be read to require some review of the quality of a decision. Indeed, in Sam Wong & Son, Inc. v. New York Mercantile Exchange,\textsuperscript{63} Judge Friendly explicitly held that "[a]bsent some basis in reason, action could hardly be in good faith even [if the actor had no] ulterior motive."\textsuperscript{64} Similarly, even courts that seem to use the term "good faith" in a relatively subjective way characteristically go on to review decisions for quality under the guise of the rule that if a decision is irrational, egregious, or the like, this shows bad faith.\textsuperscript{65}

A final problem with a pure good-faith standard is that it puts the courts under great pressure to enormously expand the meaning of bad faith. In RJR, for example, Chancellor Allen stated that although directors or officers who act out of greed obviously act in bad faith, so also "any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation," and action on the basis of such an emotion therefore constitutes bad faith.\textsuperscript{66} Accordingly, Allen concluded, the protection of the business-

\textsuperscript{62} Id. § 2-103 (emphasis added).
\textsuperscript{63} 735 F.2d 653 (2d Cir. 1984).
\textsuperscript{64} Id. at 678 n.32. By "rationality" Judge Friendly stated that the court meant "only a minimal requirement of some basis in reason—not a showing that the . . . action constituted the optimal response." Id.
\textsuperscript{65} For example in RJR, Chancellor Allen stated: "As I conceptualize the matter, such limited substantive review as the [business judgment] rule contemplates (i.e., is the judgment under review "egregious" or "irrational" or "so beyond reason," etc.) really is a way of inferring bad faith." In re RJR Nabisco Shareholders Litigation, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 at 91,710 n.13 (Del. Ch. Jan. 31, 1989).

In still other cases, a court that purports to employ a pure good-faith standard achieves the same result as a review of the quality of a decision, simply by finding that the director or officer had not properly informed himself. An example is Woodruff v. Tomlin, 616 F.2d 924 (6th Cir.), cert. denied, 449 U.S. 888 (1980) a legal-malpractice case decided by the Sixth Circuit under Tennessee law. The complaint was predicated on various acts and omissions by Tomlin in the conduct of a trial, one of which was his failure to interview and present certain potential witnesses who had been suggested to him by the client. The Sixth Circuit held that under Tennessee law there was no liability for acts and omissions by an attorney in the conduct of litigation that were based on the attorney's honest exercise of professional judgment. It nevertheless concluded the failure to interview witnesses suggested by the client raised a jury question: "If the persons mentioned by . . . [the client] were prepared to testify as he believed they would, their evidence would have been material to the issues in the case. Without interviewing them, Tomlin had no basis for determining what they would testify to, if called, or for making a judgment as to their effectiveness as witnesses." Woodruff, 616 F.2d at 934.

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judgment rule would be unavailable to a director or officer who acted out of "hatred, lust, envy, revenge, . . . shame or pride."\(^{67}\) As Allen's list makes clear, a full-blooded version of a good-faith standard might well expand rather than contract the liability of directors and officers.

For the most part, therefore, the courts have not employed a good-faith standard in applying the business-judgment rule, but instead have employed a standard that involves some review for quality, however limited. As William Quillen, formerly a leading Delaware judge, has stated: "[T]here can be no question that for years the courts have in fact reviewed directors' business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries."\(^{68}\)

This is as it should be. Unlike a pure good-faith standard, a rationality standard represents an appropriate balance of the relevant considerations of fairness and policy. A rationality standard gives enormous scope to the decisions of directors and officers, so as not to discourage them from making bold decisions and not to subject them to an undue likelihood that they will unfairly be held liable simply because their decisions turn out badly. At the same time, however, a rationality standard preserves a minimum and necessary degree of accountability on the part of directors and officers, and allows the courts to enjoin actions of fiduciaries that threaten to waste the assets of their beneficiaries by dealing with those assets in a manner that lacks a rational basis.

**VI. LIMITATION OF LIABILITY**

A very recent development that affects the duty of care of directors and officers is the enactment of statutes in a number of states that

\(^{67}\) Id.  

The label that the lawyer defenders of corporate management are trying to preserve as a prerequisite for director liability is fraud. The label also appears explicitly in some cases as if the judges find themselves more comfortable with fiction than with fact. "[I]nadequacy of price will not suffice to condemn the transaction as fraudulent, unless the inadequacy is so gross as to display itself as a badge of fraud." Thus, there is a merging of two factors, the taint factor and the decision factor. "Honest mistakes" are contrasted with decisions made so . . . as to carry a dishonest badge. There is nothing unique about the concept of constructive fraud. A constructive contract is not a contract, a constructive trust is not a trust, and constructive fraud is not fraud. But we are dealing with fictions. It would be better if we dealt in truth.

Id. at 494.
permit the certificate of incorporation to limit the remedies for violation of that duty. These statutes vary considerably in their approach. The Delaware statute is undoubtedly the most important, both because of the centrality of Delaware in corporation law and because that statute has served as the prototype for a number of others. Under section 102(b)(7) of the Delaware statute, the certificate of incorporation may contain:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith of which involve intentional misconduct or a knowing violation of law, (iii) [for improper distributions], or (iv) for any transaction from which the director derived an improper personal benefit.

Although at first glance this statute might seem to enable the virtual elimination of the duty of care, the statute falls short of taking that position, because of three important limitations.

First, the statute does not permit a certificate provision to eliminate or limit liability for "acts or omissions not in good faith or which involve intentional misconduct." The meaning of these terms will have to be developed by judicial interpretation, but "good faith" may very well have an objective content, and a complete failure to monitor, or to follow up on an information that requires further inquiry, might be construed as "willful misconduct."

Second, the statute does not permit a certificate provision to limit injunctive relief.

Finally, the statute applies only to directors; it does not permit a certificate provision to eliminate or limit the liability of officers.

The concept of limiting the liability of directors for violations of the duty of care that do not involve a lack of good faith or willful misconduct is appealing. Massive liability for outside directors would often be all out of proportion to the fault involved. Moreover, in the absence of some limitation it might prove difficult to attract highly qualified individuals to serve as outside directors. For many potential


70. DEL. CODE ANN. tit. 6, § 102(b)(7) (Supp. 1988).
outside directors, such as CEOs of other corporations, the usual directors' fee of, say, $30,000-$40,000 a year, is a relatively small amount.\textsuperscript{71} Of course, directorships carry valuable nonfinancial benefits, such as prestige, contacts, and a broader perspective on one's own business. Nevertheless, the financial and nonfinancial benefits may easily be swamped by the risk of a massive judgment for a violation of the duty of care. The relatively low compensation of outside directors also makes the problem of undue risk-aversion especially salient: in the absence of a limit on liability an outside director will gain little or nothing personally if a risky decision pays off, but might stand to lose enormously if it does not.\textsuperscript{72}

Accordingly, it would be appropriate to reasonably limit the liability of outside directors for simple violations of the duty of care—for example, to an amount related to the director's compensation. Unfortunately, the Delaware statute goes much further. It permits the complete elimination of directorial liability for violation of the duty of care, at least within the stated exceptions, which cover only a portion of the duty. This approach can create serious shortfalls in the corporate system. As Burgman and Cox observe:

\begin{quote}
[In a world of no enforceable duty of care, the] notion that directors and managers must exercise care in the service of shareholders . . . is deprived of its status as a controlling conception of manager and director role.

\ldots

\ldots [T]here is a value to retaining and enforcing an authoritative definition of standards of conduct for persons who are not merely "private parties," but \ldots fiduciaries acting on behalf of and for the benefit of the complex of interests that is the corporation. \ldots Perhaps the value is best understood if stated negatively, as a rejection of the notion that the board is or ought to be its own judge of the standard of conduct that will be demanded of it . . . .\textsuperscript{73}
\end{quote}

The objective of the duty of care is not only to provide for compensation. Another, more important objective is to provide for accountability. Of course, directors can be called to account through other techniques, such as proxy voting, but these techniques all have significant limitations, and historically the law has added to these techniques the duty of care. Admittedly, the duty of care itself has significant limita-

\textsuperscript{71} This too is desirable. If directors' fees were too large, many outside directors would not really be independent.


\textsuperscript{73} Burgman & Cox, supra note 55, at 362-63, 364.
tions, and is only a marginal technique for accountability; certainly the corporate system would be in trouble if it depended primarily on liability rules to ensure proper performance by directors. Nevertheless, in a system where accountability is limited even marginal techniques are important. It is not without significance that the enactment of section 102(b)(7) of the Delaware statute was associated with a significant decrease in the value of Delaware corporations taken as a group, and that proposals by corporations to adopt provisions under section 102(b)(7) are associated with a negative effect on the value of those corporations.\footnote{74}{Bradley & Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1, 48, 60-65 (1989).}

\section*{VII. Conclusion}

The duty of care is not without its problems. Nevertheless, it has served as a critical component of the corporate system in this country. That system has flourished in part because it has included mechanisms that combine accountability with minimal government intervention. Any substantial diminution of those mechanisms of accountability are likely to lead, sooner or later, to increased government intervention. Directors and officers should have all appropriate protection against the imposition of liability for bold decisions that happen to turn out badly, and against the imposition of liability that is disproportionate to fault. However, they also must be subject to the general rule that if a private individual assumes a role whose performance involves a risk of injury to others, he is under a moral and legal obligation to perform the role with due care.