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SUPPLEMENTAL READINGS

Class 10

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Corporations

and Other Business Entities

Seventh Edition

Steven L. Emanuel

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CORPORATIONS
AND OTHER BUSINESS ENTITIES

SEVENTH EDITION

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This book is intended as a general review of a legal subject. It is not intended as a source of advice for the solution of legal matters or problems. For advice on legal matters, the reader should consult an attorney.

CHAPTER 3

THE CORPORATE STRUCTURE

ChapterScope

This Chapter discusses the powers of directors, officers, and shareholders, respectively. The main concepts are:

- **Straight vs. cumulative voting:** In all elections for directors, the number of votes a shareholder gets equals the number of shares she holds, multiplied by the number of directors standing for election. But there are two distinct methods by which these shares can be voted, "straight" and "cumulative."
  - **Straight voting:** In ***"straight"*** voting, ***no share*** may be ***voted more than once*** for any given candidate.
  - **Cumulative voting:** In ***"cumulative"*** voting, by contrast, a voter may vote a single share ***multiple times for a single candidate*** (once for each director seat that's open). This increases the ***power of minority shareholders***, since a shareholder may cumulate (i.e., lump together) all his votes so as to be sure to elect a single director.
- **Quorum:** At both a shareholders' meeting and a board of directors' meeting, no action may be taken without a ***"quorum."***
  - **Board meeting:** At a ***board*** meeting, a quorum is usually a majority of the ***directors in office.***
  - **Shareholders' meeting:** At a ***shareholders'*** meeting, a quorum is usually a ***majority of the outstanding shares.***
- **Shareholders' powers:** Shareholders are the owners of stock in the corporation. They have two main sets of powers:
  - **Vote for directors:** First (and most important) they ***elect the members of the board of directors.***
  - **Approval of fundamental changes:** Second, they ***approve or***

disapprove major changes to the corporation. For instance, the corporation cannot sell substantially all of its assets, or merge into another corporation, unless the shareholders so vote.

- **Directors:** The board of directors ***manages the corporation,*** at the ***policy*** level.
  - **Appointment of officers:** A key aspect of directors’ powers is that the board votes to ***appoint the “officers” of the corporation***, who are its day-to-day managers. For example, the board elects the president.
  - **Setting of policy:** The board also ***sets major policy.*** For instance, any non-trivial acquisition of another company’s stock or assets would have to be approved by the board.
  - **Requirements for board action:** A key focus with respect to directors is, What are the requirements for valid ***action*** by the board? (For instance, there must be a quorum present at a directors’ meeting; the board must normally act by majority vote of those present, etc.)
- **Officers:** Officers administer the ***day-to-day affairs*** of the corporation. They are appointed by the board.
  - **Authority of officers:** Whenever an officer acts on behalf of the corporation, a key issue is, Was this action ***authorized***? If the action was not in any sense “authorized,” it’s ***not binding*** on the corporation. An officer’s authority may be ***express***, ***implied***, or ***apparent***.
  - **Ratification:** However, even if the officer acted completely without authority, ***later actions*** by other officers or by the board may amount to a ***“ratification”*** of the act, binding the corporation.

I. GENERAL ALLOCATION OF POWER: SHAREHOLDERS, DIRECTORS AND OFFICERS

A. The traditional statutory scheme: Traditionally, powers have been allocated among the shareholders, the directors and the officers of a corporation in a particular way. Even today, most statutes assume that this allocation of powers will be followed. Therefore, we refer to it as the ***“statutory scheme.”*** However, most modern statutes allow the corporation, if it observes certain formalities, to ***modify*** this scheme.

1. **The statutory scheme:** The statutory scheme may be summarized as follows:

   a. **Shareholders:** The ***shareholders*** act principally through two mechanisms: (1) ***electing and removing directors***, and (2) approving or disapproving ***fundamental or non-ordinary changes*** (e.g., mergers).

   b. **Directors:** The ***directors*** "***manage***" the corporation's business. That is, they formulate policy, and appoint officers to carry out that policy.

   c. **Officers:** The corporation's ***officers*** administer ***the day-to-day affairs*** of the corporation, under the supervision of the board.

2. **Inappropriate structure for very large or very small corporations:** For very large or very small corporations, this statutory scheme does not reflect reality. For instance, a small closely-held corporation generally does not have its affairs managed by the board of directors — the shareholders usually exercise control directly (they may happen also to be directors, but they usually do not act as a body of directors, and the controlling shareholders often disregard any non-shareholder directors). At the other end of the spectrum, a very large publicly-held company is really run by its officers, and the board of directors frequently serves as little more than a "rubber stamp" to approve decisions made by officers.

3. **Modification of statutory scheme:** Modern statutes generally give the corporation the power to modify this traditional statutory scheme where appropriate. This is especially true for closely-held corporations, as is discussed *infra*, p. 134. (For instance, some statutes allow closely-held corporations to reduce the board to one or two members; see *infra*, p. 59.) But unless a particular modification of the statutory scheme is explicitly authorized by statute, the corporation and its lawyer disregard

the statutory scheme ***at their peril***. Much of this chapter is devoted to an explanation of the statutory scheme in detail, together with a description of the consequences if the traditional scheme is not actually followed by the corporation.

4. **Focus of this section:** The rest of this section I is an overview of the division of powers as among the shareholders, directors and officers. Following that, sections II, III and IV examine the mechanisms by which the board, the officers and the shareholders, respectively, exercise their powers.

B. Powers of shareholders: Under the statutory scheme, the shareholders do ***not directly manage*** the corporation, even though they own it. Instead, they can influence the conduct of the business through a number of ***indirect*** methods.

1. **Four methods:** There are four main methods by which the shareholders can influence the corporation's affairs:

   a. **Elect and remove directors:** They have the power to ***elect*** and ***remove directors***;

   b. **Articles of incorporation and bylaws:** They can approve or disapprove of changes to the ***articles of incorporation*** or ***bylaws*** and thereby influence the allocation of power as among themselves, the directors, and the officers. See *supra*, p. 23. (For instance, the powers and duties of executive officers are usually spelled out in the bylaws, so these powers and duties could be cut back or re-allocated based partly on shareholder-approved bylaw changes.)

   c. **Fundamental changes:** They have the right to approve or disapprove of ***fundamental changes*** not in the ordinary course of business, such as a ***merger***, a sale of substantially all of the corporation's assets, or dissolution.

   d. **Void or voidable transactions:** Finally, some transactions by officers or board of directors are ***void*** or ***voidable*** unless ratified by a vote of shareholders. For instance, many transactions between the corporation and a director or officer are voidable on grounds of self-dealing unless the shareholders ratify the transaction by voting to approve it. See *infra* p. 200.

See generally Nutshell, pp. 155-56.

2. **Election and removal of directors:** Because the shareholders' power to ***elect and remove directors*** is so important, we give it special attention here (as well as on p. 55):

   a. **Election:** Directors are normally elected at ***each annual meeting*** of shareholders. That is, directors normally serve a ***one-year term*** (though of course they can be, and often are, re-elected). See MBCA §8.05(b).

      i. **Staggered terms:** The one common exception to annual terms is that in most states, if the articles of incorporation so provide, the directors may have ***staggered terms***. That is, the directors may be initially divided into, say, three "classes," with one class having a three-year term, another a two-year term and the last a one-year term. This classification device, which is often used today to make it more difficult for a "raider" to replace the board, is discussed further *infra*, p. 451.

   b. **Vacancies:** Shareholders are generally given the power to elect directors to fill ***vacancies*** on the board, but the board of directors also usually has this power. There fore, the filling of vacancies is discussed in the treatment of the board of directors, *infra*, p. 60.

   c. **Removal of directors:** At common law, shareholders had little power to ***remove*** a director during his term of office. But modern statutes have dramatically expanded this shareholder power. The topic of shareholder-removal of directors is discussed more fully *infra*, p. 61, as part of our more general discussion of the ways in which directors may be removed.

3. **No power to bind corporation:** The shareholders do ***not*** have the power to ***conduct business*** directly on behalf of the corporation. (They must operate through their control of the board.) This means that shareholders cannot ***bind the***

corporation by their own direct actions. And this is true even of actions taken by a majority of shareholders, purportedly in the corporation's name — unless the action is somehow ratified by the board or by an officer with power to bind the corporation to the kind of transaction in question (see *infra*, p. 73), the action by the shareholders has ***no effect***.

Example: Sam is a majority shareholder of Corp., but does not sit on the board and is not an officer. He goes to Copy Machine Co. and signs a contract (made out in Corp's name) to purchase a copy machine. The board learns of this before the machine is delivered, and sends a letter to Copy Machine saying, "We're not bound to take this copier, and we don't want it." Copy Machine can't hold Corp. to the contract, because Sam is merely a shareholder (albeit a majority one), not an officer, and shareholders *qua* shareholders can't bind a corporation.

C. The power of directors: Traditionally, state corporation statutes have provided that the board of directors shall ***"manage"*** the affairs of the corporation. These statutes generally view the board not as agents of the stockholders, but as an ***independent institution*** with responsibility for supervising the corporation's affairs. C&E, p. 287.

1. Shareholders can't give orders: Thus traditionally (and probably even under recently-revised statutes), the shareholders ***cannot order the board of directors to take any particular action***. It is the board, not the shareholders, who formulate policy; shareholder control is limited to removing directors (see *supra*) or approving or disapproving certain major actions contemplated by the board (e.g., mergers).

2. Supervisory role: Although older statutes still say that the board of directors shall "manage" the corporation, the reality is that day-to-day management is carried out by the corporation's ***officers***, under the ***supervision of the board of directors***. Some modern statutes now recognize this fact. For instance, the MBCA says that "All corporate powers shall be exercised ***by or under***

the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be ***managed by or under the direction***, and subject to the ***oversight***, of its board of directors.…" §8.01(b). (The role of officers is described *infra*, p. 72.)

a. **Sets policy:** Thus today, the board's main function is to ***set the policies*** of the corporation, and to authorize the making of important contracts. Nutshell, pp. 161-62. It is also the board which declares dividends; this responsibility is given to it specifically by statute. See *infra*, p. 505. Beyond this, it is usually up to the board to initiate fundamental changes in the corporation (e.g., mergers or large asset sales), though these must then be submitted to the shareholders for approval.

D. **Power of officers:** According to the statutory scheme, the corporation's ***officers*** serve under and at the will of the board of directors and carry out the ***day-to-day operations*** of the corporation. In practice, of course, the officers frequently have much greater power than this implies, especially in large publicly-held corporations. But the important thing to remember is that, as far as most corporate statutes contemplate, the officers are essentially ***"agents"*** of the board of directors. (This "agency" view has major implications for the power of an officer to bind the corporation as his "principal"; see *infra*, p. 73.)

E. **Sharing of responsibility:** From the above discussion, it might sound as though shareholders have very little ability to influence the corporation's affairs, apart from election and removal of directors. However, there are a number of additional ways in which shareholders at least get to ***share*** some of the power over corporate operations:

1. **Shareholder resolutions:** As noted, shareholders cannot require the directors or officers to take any particular action during the corporation's day-to-day operations. However, shareholders can seek to ***influence*** the board by exercising their right to adopt ***share-holder resolutions*** that ***recommend*** particular actions to the board (even though the board can't be

required to follow the resolution's recommendations).

2. **Self-interested transactions:** Also, transactions in which the board or officers are ***personally interested*** are almost always put to a shareholder vote. Thus ***incentive compensation*** plans that cover officers, and arrangements whereby the corporation indemnifies directors or officers against liability (see *infra*, p. 341), are almost always put to a shareholder vote.

   a. **Effect of ratification:** If such a transaction in which directors or officers are personally interested is ratified by the shareholders, this generally does not completely immunize the planned transaction against attack. But individual shareholders who vote for it can't attack the transaction later on; also, approval may make it harder for opposing shareholders to attack the transaction on grounds of general unfairness, by shifting the burden of proof to them from management. (But a court will still set aside a transaction involving officers or directors that is fraudulent or "manifestly unfair." See *infra*, p. 200.) See Nutshell, p. 165.

3. **Fundamental changes:** Lastly, shareholders are always given the power to approve or disapprove of certain ***fundamental changes*** in the corporation. For instance, in most states the following kinds of changes are ineffective without shareholder approval:

   [1] ***mergers***;

   [2] ***sales*** of all or substantially all of the corporation's ***assets***;

   [3] ***amendments*** of the articles of incorporation;

   [4] statutory ***share exchanges*** (see *infra*, p. 310), in which all shareholders are required to exchange their shares for those in another corporation; and

   [5] ***dissolution*** of the corporation.

   But observe that in most states the power to effect these changes does not reside exclusively in the shareholders: Only if the board of directors first decides to put the matter to a shareholder vote does the vote occur. This is sometimes referred to as the board of directors' ***"gatekeeping"*** function. See, e.g., MBCA §11.04(b) (shareholders only get to vote if the board submits the proposed merger or share exchange to them.)

a. Amendment of bylaws: In recent years, another significant avenue by which shareholders may assert power has begun to emerge: the ability to ***amend*** the corporation's ***bylaws***. Recall (*supra*, p. 23) that most states allow the bylaws to be amended either by the board or the shareholders. Under the law of some states, practically any topic may be covered by a bylaw as long as the bylaw does not conflict with the certificate of incorporation. Although bylaws typically deal with non-controversial ***procedural*** matters (e.g., the date of the shareholders meeting, or how board elections are to be conducted), there is often nothing in state law to prevent bylaws from dealing with weightier matters on which the board and shareholders may disagree. Consequently, the shareholders may be able to change the corporation's policies in major ways over the objection of the board, by voting a bylaw change.

Example: In *Int'l Brotherhood of Teamsters v. Fleming Cos.*, 975 P.2d 907 (Ok. 1999), the court affirmed the right of shareholders of an Oklahoma corporation to pass a bylaw cancelling an ***anti-takeover device*** that the board had enacted.

i. State-law limits on bylaws: But some states do significantly limit the content of bylaws. For instance, in Delaware, "a proper function of bylaws is ***not*** to mandate how the board should decide ***specific substantive business decisions***, but rather, to define the ***process and procedures*** by which those decisions are made." *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008). So a bylaw amendment to the charter of a Delaware corporation would be unlawful if the amendment purported to significantly ***limit the board's discretion*** over substantive matters, especially in a way that deprived the board of its ability to ***exercise its fiduciary responsibilities*** to all shareholders. See *CA, Inc.* (discussed in detail *infra*, p. 115) for a fact pattern in which such an illegal limitation in a bylaw occurred.

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(GENERAL ALLOCATION OF POWER)*

15. Alfred Pennyworth is a 51% owner of Metropolis Crimefighters, Inc. Metropolis has two officers who serve as its directors and employees, Batman and Robin. Alfred is not a director or officer of the corporation. Alfred is out shopping one day when he sees a nice, sedate station wagon, the Travel Queen Family Truckster, which he thinks would make a far more sensible company car than the Batmobile. He signs a lease for the Travel Queen on behalf of Metropolis. When Batman and Robin see the Travel Queen, Robin exclaims, "Holy Corporations, Batman! Is Metropolis Crimefighters bound by this lease?" Well — is it?

____

Answers

15. No. The issue here is the extent to which an *owner* of a corporation (i.e., a shareholder) may conduct corporate business. Here, that's all Alfred is; he's neither a director nor an officer. The rule is that shareholders have no authority to conduct corporate business; the board of directors has such authority, which it may delegate to officers or subordinates. Thus, a shareholder who is not an officer or director cannot enter into a contract on the corporation's behalf, unless the board has explicitly given him authority to do so. And that's true even where the shareholder owns a majority of the shares (and could therefore replace a majority of the board with a compliant one that would do what he wants.) [52]

II. THE BOARD OF DIRECTORS

A. Generally: We cover now the mechanics of the board of directors, including (1) how the board is ***elected***; (2) how it holds its ***meetings***; (3) what ***formalities*** it must observe in order to take action; and (4) how it may make use of ***committees***.

B. Election of board members: As noted, members of the board of directors are always ***elected by the shareholders*** (with the possible exception of the filling of vacancies; see *infra*, p. 60). Normally, a director's term is one year, and the entire board stands for re-election at the annual meeting of shareholders.

1. Pre-conditions for a valid vote: Before we get into the intricacies of board elections, understand that the stockholder vote to elect directors must satisfy the same basic ***procedural requirements*** as a stockholder vote to take any other action (e.g., to approve the sale of the company.) This means that:

a. Notice: Proper ***notice*** of the time and place of the meeting must be given to all shareholders. See, e.g., MBCA §7.05(a).

b. Quorum: A ***quorum*** must be present. That is, ***more than 50% of the shares eligible to vote*** must be "present," either in person or via a valid proxy. See, e.g., MBCA §7.25(a). (For a discussion of proxies, see p. 97.)

2. Straight vs. cumulative voting: The vote for directors may either be ***"straight"*** or ***"cumulative,"*** depending on the state's corporation statute and the articles of incorporation.

3. Definition of "straight" voting: In ***straight*** voting, each share may be voted for as many candidates as there are slots on the board, but no share may be voted more than once for any given candidate. Directors are elected by a ***plurality*** (not necessarily majority) of the votes cast. See MBCA §7.28(a). Each share has one vote.

Example: In a closely-held corporation, A and B are the sole shareholders. A holds 72 shares and B holds 28. The board has three directors. A's candidates are A1, A2 and A3; B's candidates are B1, B2 and B3. If there is straight voting, A cannot cast more than 72 votes for any single candidate, and (most importantly), B cannot cast more than 28 votes for any candidate. Therefore, A's three candidates will receive 72 votes each, B's three candidates will receive 28 votes each, and *A's candidates will get all the seats on the board*.

4. **Cumulative voting:** The result in the above example looks pretty unfair to B. Although he has almost one-third of the votes, he has no representation on the board. In fact, even if he had 49 votes to A's 51, he still would not get a board seat under straight voting, since each of A's candidates would receive 51 votes and each of B's would get 49. To remedy this inadequate representation of minority shareholders, the device of ***cumulative*** voting was invented. As the name implies, cumulative voting entitles a shareholder to ***cumulate*** or ***aggregate*** his votes in favor of ***fewer candidates*** than there are slots available, including in the extreme case aggregating all of his votes for just one candidate. The consequences are that ***a minority shareholder is far more likely to be able to obtain at least one seat on the board***.

   Example: Assume the same facts as the above example: A has 72 votes, B has 28 votes and there are three directors to be elected. This time, however, cumulative voting is permitted. B can therefore take his entire "package" of 84 votes (28 shares x three seats) and put it all on his single favorite candidate, whom we'll call B1. B1 therefore has 84 votes. Now, no matter how A divides up his 216 votes (72 shares x 3 seats), he cannot come up with three candidates all of whom beat B1. For instance, if he casts 85 votes for A1 and 85 votes for A2 (the minimum necessary for A1 and A2 to beat B1), he has used up 170 votes, and has only 46 votes left to put on A3. Therefore, even though B has only 28% of the shares and 28% of the total votes castable in the election, he is assured of at least one seat on a three-seat board by the device of cumulative voting.

   a. **Formula:** Here is a simple formula that shows the minimum number of shares needed to elect ***one director*** under cumulative voting:

$$\frac{S}{D+1}+1$$

where *S* = the total number of shares voting and *D* = the number of directors to be elected.

Using this formula on our above example, there were 100 shares being voted, and three directors to be elected. Therefore, we have:

$$\frac{100}{4} + 1$$

so that even had B had as few as 26 shares (with A having the remaining 74), B would have been able to elect one director on a three-seat board.

i. Multiple directors: An analogous formula tells the number of shares needed to elect *n* directors:

$$\frac{nS}{D+1} + 1$$

To illustrate the use of this formula, suppose there are three shareholders A, B and C, and a total of 100 shares to be allocated. The board of directors will have five seats. A wants to know how many shares he will need if he is to deny seats to B and C (assuming that they act together to pool their votes). A will therefore need to elect all five directors, so the formula gives us (500/6) + 1, or 83 1/3 + 1, or 84 1/3. Actually, we can round the resulting number down to the nearest whole share. Therefore, A needs at least 84 of the 100 shares in order to deny B and C a seat on a five-seat board. See generally Nutshell, pp. 184-88.

b. Mandatory or permissive cumulative voting: As of 2002, all states at least ***permitted*** cumulative voting if the corporation desires it, and some states ***required*** it. Hamilton (8th), p. 551. There are three ways in which cumulative voting is handled in statutes:

i. Mandatory: Seven states make cumulative voting ***mandatory*** by a statutory or state constitutional provision.

Id. In these states, even an amendment to the corporation's articles of incorporation specifically banning cumulative voting will be ineffective.

ii. "Opt in" election: Thirty states permit cumulative voting, but only if the articles of incorporation specifically elect to have it (an ***"opt in"*** election). *Id*. The MBCA follows this path; see §7.28(b).

iii. "Opt out" election: Finally, thirteen states provide that cumulative voting is allowed unless the articles of incorporation explicitly exclude it (an ***"opt out"*** election). Hamilton (8th), p. 551.

c. Trickiness: When cumulative voting is allowed, voting strategy can be quite tricky. Most dramatically, it can be catastrophic to A to use straight voting when, unbeknownst to him, B is using cumulative voting.

Example: A owns 60 shares, B owns 40 shares and the board consists of five directors to be elected. Suppose A is unaware that cumulative voting is allowed and that B will be using it. A therefore casts 60 votes for each of his five candidates, A1, A2, A3, A4 and A5. B, knowing or suspecting that A is doing this, allocates his votes as follows: B1-68, B2-67 and B3-65 (with nothing for a fourth or fifth candidate). By this strategy, B ends up ***controlling the board*** with three directors even though he has only 40% of the shares!

Note: However, B's strategy in the above example could easily backfire if A learns or guesses what is going on. For instance, A can cast 75 votes for each of A1, A2, A3, and A4 (with nothing for A5). If A does so, B's strategy will have backfired — A will have four of the five seats, one more than he would have gotten had B followed the "conservative" cumulative strategy of splitting his votes among only two candidates (the maximum number that he could be sure of electing regardless of A's strategy).

i. Ties: It is poor strategy for a shareholder to create a ***tie***

among his own candidates. The reason is that if there is a tie for the last place on the board, this will result in a ***separate election*** for the last seat, at which cumulative voting will not apply. This may result in the minority shareholder's losing a seat he could otherwise have gotten. See Nutshell, p. 187.

ii. Advance notice: A few states require shareholders to give ***advance notice*** before they use cumulative voting. California, Hawaii, Minnesota, North Carolina and Ohio are among such states. See H&A, p. 496, n. 19. Similarly, MBCA §7.28(d) provides that either: (1) the notice to shareholders of the annual meeting must state "conspicuously" that cumulative voting is authorized, or (2) the shareholder must give 48-hour notice to the corporation that he intends to vote cumulatively (in which case the other shareholders may cumulate without any further notice). This helps eliminate the unfair results that can occur if one shareholder votes cumulatively while the other does not, as in the example *supra*, p. 57.

iii. May change vote until announcement: Unfair surprise is also reduced by the fact that a shareholders' vote is ***not final*** until it is ***announced*** by the chairperson at the meeting. Thus even if in the above example A and B have both cast and submitted their written votes, if A suddenly realizes that B is cumulating, he can resubmit his own votes on a cumulative basis. H&A, p. 496.

d. Reduction in board size: Observe that one way to ***reduce the impact*** of cumulative voting is ***to reduce the size*** of the board.

Example: Suppose that A has 80 shares and B has 20 shares. If there are five seats on the board, cumulative voting assures B of getting a seat. (By the formula on p. 56, even as few as 17 of the 100 shares would guarantee B a seat on a five-person board.) But if the board is reduced to three seats, B will lose his guaranteed seats. Now, by the same formula, B needs at least (100/4) + 1, or 26, of the 100 shares in order to guarantee himself a seat.

e. Staggered terms: A second, similar way of reducing the effect of cumulative voting, is the use of ***staggered terms*** for the board of directors. That is, the board may be divided into, say, three "classes" of directors, one class elected for a one-year term, another for a two-year term, and the last for a three-year term. Once the initial election of each class has taken place, re-election of each class is for the same term (probably for three years).

Example: A has 79 shares and B has 21. The board has nine seats. If all directors are elected for one-year terms at each annual meeting, B is guaranteed at least two of the nine seats by cumulative voting — by the formula on p. 56,

$$\frac{200}{9+1} + 1 = 21$$

Now, assume that the board is divided into three "classes," each consisting of three directors; class A will stand for re-election in year one, class B in year two, and class C in year three. Each annual election now involves only three directors and B will go from having a guaranteed two seats to having *zero* guaranteed seats (since by the formula on p. 56, a shareholder needs at least 26 of 100 votes to be sure to fill one of three available seats in an election).

i. Upheld by court: The effect of staggered terms on cumulative voting is so severe that in those states where cumulative voting is required by statute or constitution (see *supra*, p. 57), minority shareholders have tried to convince courts that the adoption of staggered terms amounts to an automatic violation of cumulative voting. In one or two states, this argument has succeeded, but in most it has not. See H&A, p. 496, n. 21.

f. Merits of cumulative voting: The merits of cumulative voting depend largely on how widely dispersed ownership is.

In a closely-held corporation, cumulative voting serves the very useful purpose of insuring that the holders of a minority, but significant, stake in the corporation are not "frozen out" from the board. But in a publicly-held corporation whose ownership is widely dispersed, cumulative voting can be more of a nuisance than a value, since it greatly complicates the mechanism of voting by proxy, yet will rarely affect the outcome. See Nutshell, p. 187. Management usually opposes cumulative voting, both on this ground and on the ground that it produces an ***adversarial board***. See K&C, p. 124-25.

g. **Removal of cumulatively-elected directors:** Recall that in most states today, shareholders have the right to ***remove*** a director without cause at any time during his term. See *supra*, p. 56 (as well as *infra*, p. 62). How does this right, where it exists, interact with cumulative voting? If an election to remove without cause were done by a straight "yes or no" vote at which the majority of votes cast determined the result, the right of cumulative voting would be ***completely nullified***: the holder of fifty-one percent of the shares could allow the minority to use its cumulative votes to elect, say, four seats on a nine-member board, but then could immediately prevail in a majority-vote election to remove those four without cause. Consequently, most states have a special provision to prevent this; see *infra*, p. 63.

C. **Number of directors:** Traditionally, most statutes require that there be at least three directors. But today, many states allow a board to consist of less than three so long as it is equal to the number of shareholders — thus a one-shareholder corporation can have one director and a two-shareholder corporation can have two directors. (California and New York are among these states. See H&A, p. 551, n. 1.)

1. **Minimums abolished:** A substantial (and growing) minority of states, in fact, now allow a corporation to have a one- or two-member board ***even if there are more than two share-holders.*** This is now true of Delaware (§141(b)) and the MBCA (§8.03(a)). See H&A, p. 552, n. 2.

a. **Rationale:** There seems little reason to require that there be more than one or two board members merely because there are, say, three shareholders. For instance, suppose that A owns all the stock of a corporation, and is the sole director. If he makes a gift of a few shares to each of his children, all of a sudden he would have to expand his board to three, a move that has no business justification. Nutshell, p. 217.

2. **Stated in articles or bylaws:** The number of directors is usually fixed either in the ***articles of incorporation*** or in the ***bylaws***. Most statutes leave it up to the corporation whether this should be done in the articles or the bylaws; see e.g., MBCA §8.03(a). Observe that if the number is specified in the articles, it may only be changed by shareholder vote; but if it is set in the bylaws, it may usually be changed by the board itself, under the board's general power to amend bylaws (see *supra*, p. 23).

a. **Restrictions on scope of change:** However, corporation statutes sometimes prevent the board from making very large changes in its size without shareholder approval, even if the bylaws allow the board to change the number of directors. For instance, MBCA §8.03(b) provides that even if the board has power to change the number of directors, it may increase or decrease the board only by ***thirty percent*** or less without shareholder approval.

3. **Variable board size:** Most statutes allow the articles of incorporation or bylaws to set a ***minimum*** and ***maximum*** size for the board, rather than a fixed size. When this approach is followed, either the shareholders or the board may adjust the size within the range, but only the shareholders may change the range itself. MBCA §8.03(b) follows this pattern.

a. **Rationale:** Observe that the MBCA's handling of changes in the number of directors leaves some scope for the board to make modest changes, but requires shareholder approval for large changes. This is true whether the corporation uses a fixed or variable number of directors. Thus under the MBCA scheme the board may usually decide whether to fill one or a small number of vacancies without seeking shareholder approval but may not dramatically expand the power of incumbent directors (by refusing to fill a large number of vacancies) without going back to the shareholders. See MBCA §8.03(b); see also Nutshell, p. 219.

D. **Filling of vacancies:** Most statutes allow ***vacancies*** on the board to be filled ***either*** by the shareholders or by the board, unless the articles of incorporation provide otherwise. See e.g., MBCA §8.10(a).

1. **Term:** Some statutes let the replacement director serve the ***full unexpired term*** of his predecessor. Others require her to ***stand for re-election*** at the ***next annual meeting***. The two rules differ only where the board is staggered (see *supra*, p. 58); under the former rule, if A resigns with two and one-half years left on his three-year term, his successor gets to serve the full two and one-half years, whereas under the latter rule the successor must stand for re-election in six months.

   a. **MBCA:** MBCA §8.05(d) requires that the replacement stand for re-election at the next annual meeting.

2. **Increase in number on board:** Some statutes distinguish between vacancies created by resignation (an "old" vacancy) and those created because the size of the board is increased (a "new" vacancy). States making this distinction usually allow the board to fill old vacancies but not new vacancies. Nutshell, p. 222. But many states have abolished this distinction; see e.g., MBCA §8.10(a), explicitly giving the board the right to fill vacancies "resulting from an increase in the number of directors."

3. **Election by classes of stock:** In many corporations, especially closely-held ones, a key control device is that each separate ***class of stock*** is entitled to elect a certain number of directors. For instance, if a closely-held corporation has A and B classes of stock, the B shareholders might be given the right to elect four of nine board members, even though they had only 25% of the total voting power of the corporation. If a class has the right to elect a specified number of directors, then ***only that class*** may vote to

fill a ***vacancy*** arising from the resignation of one of the directors elected by the class (assuming that it is the shareholders, rather than the board, that fill vacancies). See MBCA §8.10(b).

4. **Dated resignations:** A director may normally submit a ***dated resignation***, that is, a resignation that is to take effect at some future time. The key advantage of such a prospective resignation is that the resigning director may ***participate in the election*** of his successor (always assuming, of course, that the board is authorized, as is usually the case, to fill vacancies). See MBCA §8.10(c). This is particularly important where, without the vote of the soon-to-resign director, the board would be deadlocked between competing factions. See Nutshell, p. 224.

5. **Quorum problems:** Any board action normally requires a ***quorum*** (see p. 63), and that's true of votes by the board to elect new directors to fill board vacancies. Well, what happens if so many directors resign (without first voting for their successors), or otherwise leave the board, that a quorum of the board is no longer possible? Most states have a special rule saying that in this situation, the vacancy can be filled by majority vote of the remaining directors, ***even though no quorum is present.*** See the further discussion of this problem *infra*, p. 64.

6. **Holdover directors:** Virtually all states provide that a director holds office not only for the term for which he is elected, but ***until his successor is elected and qualified***. A director serving beyond the end of his term is called a ***holdover*** director. See, e.g., MBCA §8.05(e) ("[D]espite the expiration of a director's term, the director continues to serve until the director's successor is elected and qualifies or there is a decrease in the number of directors.")

   a. **Rationale:** Without the holdover device, a corporation could become completely deadlocked. For instance, if there were two factions with equal voting power, one faction could refuse to attend an annual meeting or to vote for directors, and the absence of a quorum at the shareholders meeting would prevent any election from taking place; holdover directors would then be the only directors. Of course, the holdover provision means that in this kind of deadlock situation, the original directors would remain in office forever; the remedy might well be involuntary dissolution of the corporation (see *infra*, p. 154). See also Nutshell, p. 225.

E. **Removal of directors:** When may a director be ***removed***? Most statutes allow this to be done by either a ***shareholder vote*** or by ***court order***.

1. **Shareholder vote:** Most modern statutes provide that directors may be removed by a majority vote of ***shareholders***, either ***with or without cause***.

a. **MBCA:** Thus MBCA §8.08(a) says that "The shareholders may remove one or more directors ***with or without cause*** unless the articles of incorporation provide that directors may be removed only for cause."

b. **Minority rule:** Even the ***minority*** of jurisdictions whose statutes do not allow shareholders to remove directors without cause in all circumstances allow it if this right is ***reserved in the articles of incorporation.***

c. **Protection of groups:** However, removal-of-director provisions are generally drafted so as to ***prevent the majority from undermining*** the effect of cumulative voting and other ***minority-protection devices***.

i. **Cumulative voting:** For instance, if a corporation has ***cumulative voting***, the statute will normally provide that a director cannot be removed if the number of votes cast against his removal would have been enough to elect him. See MBCA §8.08(c), to this effect.

Example: X Corp. is a closely-held corporation. A, B and C each have 30 shares, and D has 10 shares. X has cumulative voting, and a 5-member board. (Therefore, each shareholder voting for directors has five votes times the number of shares he holds. By the formula on p. 56, anyone who receives 100/6 + 1, or 17 2/3, votes will be elected.) D casts all his 50 votes for himself, so he is elected to the board even though no one else casts any votes for him. A, B and C later decide that they wish to remove D.

Under MBCA §8.08(c), if D casts his 50 votes against his own removal, D can't be removed, even though A, B, and C collectively cast all 450 (90 × 5) of their votes to remove him. This is so because §8.08(c) says that "If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect him under cumulative voting is voted against his removal," and more than 17 2/3 votes have been cast against D's removal.

d. **Majority of those voting:** To remove a director, it's not necessary that a majority of all shares outstanding be voted against the director, only that a majority of those votes ***actually cast*** be against the director. (This is an application of the more general rule, discussed *infra*, p. 81, that when an action requires shareholder approval, only a majority of shares actually voted, not a majority of shares outstanding, need be voted in favor.)

e. **Meeting required:** Also, keep in mind that a shareholder vote to remove a director requires the ***same formalities*** (e.g., a shareholders ***meeting***) as any other shareholder action. (See *infra*, p. 79, for more about the formalities for shareholder action.) In fact, some statutes say that there must be a special meeting of shareholders, at which the removal of the director is one of the ***stated purposes*** of the meeting. See, e.g., MBCA §8.08(d), to this effect.

f. **Significance of removal power:** There are at least two situations in which the shareholders' power to remove directors ***without cause*** has a sharp practical significance.

i. **Control shifts:** First, when through a friendly or unfriendly takeover, ***control*** of the corporation ***shifts*** (see *infra*, p. 360), this right of removal allows the new controlling owner to replace directors with "friendly" directors of his own choosing.

ii. **Closely-held corporation:** Secondly, in a ***closely-held*** corporation, the controlling shareholder(s) will frequently want to make sure that directors he elects remain "***friendly***" to him; the unrestricted right of removal helps ensure this. See Nutshell, p. 160.

2. **Court order:** Modern statutes also generally say that a ***court*** may ***order*** a director removed, but only ***for cause***.

   a. **MBCA:** For example, MBCA §8.09 says that the court may order a director removed as the result of a proceeding commenced either by the corporation or by a share-holder's derivative suit, if the court finds both that: (1) the director "engaged in ***fraudulent conduct*** with respect to the corporation or its shareholders, ***grossly abused the position of director,*** or ***intentionally inflicted harm*** on the corporation," *and* (2) "removal would be in the ***best interest*** of the corporation."

   b. **Why used:** Since the shareholders may remove the director without cause, why would a judicial proceeding ever be necessary? There are two situations in which judicial action is the only or better method of removing a director:

      [1] First, the director may be a shareholder and may possess ***such voting power*** that he can block removal by shareholder vote. (For instance, if the director was elected by cumulative voting — see *infra*, p. 56 — and votes he controls were sufficient by themselves to elect him under the cumulative scheme, he will be able to block his removal by casting the same number of votes.) Here, the board's ability to start a lawsuit to remove the director would be crucial.

      [2] Second, recall that the director can only be removed if a ***special shareholders' meeting*** occurs. If the corporation is ***publicly-held,*** and the director refuses to resign when requested to do so, this special meeting will involve considerable ***delay and expense.*** See Official Comment to MBCA §8.09.

3. **No removal of director by board action:** States generally do ***not*** allow the ***board itself*** to remove a director, ***even for cause.***

F. **Procedures for a directors' meeting:** We now examine the procedural requirements for the holding of a directors' meeting, including (1) frequency of meeting; (2) notice; and (3) quorum.

1. **Regular vs. special meetings:** There are two types of board meetings: regular and special. A ***regular*** board meeting is one which occurs at a regular interval (e.g., monthly, quarterly or annually). All other meetings are ***"special."*** The frequency for regular meetings is generally specified in the ***bylaws***.

2. **Notice:** The main distinction between regular and special meetings is that a special meeting must normally be preceded by ***notice*** to the board members, whereas this is not necessary for a regular meeting. Thus MBCA §8.22(b) provides that a special meeting must be preceded by "at least two days' notice of the date, time, and place," unless the articles or bylaws provide for a longer or shorter notice period.

a. **Waiver:** In any event, a director may ***waive*** the required notice in writing. Also, if a director ***attends*** the meeting without objecting to the lack of notice, he will generally be held to have thereby waived notice. See, e.g., MBCA §8.23(b) (attendance constitutes waiver unless the director not only objects upon his arrival but also refrains from voting in favor of, or assenting to, the proposed action at the meeting.)

b. **Purpose need not be specified:** The notice of a special directors' meeting need ***not specify*** the business to be transacted at the meeting, and any business may in fact be transacted. This is quite different from the rule governing notices of ***shareholders'*** meetings (see *infra*, p. 80). "As a result there is little practical difference between regular and special meetings of directors." Nutshell, p. 220.

3. **Quorum:** The board of directors may act only if a ***quorum*** is present.

a. **Percentage required:** If the board has a fixed size, a quorum is a ***majority of that fixed number***. This is true even though there are ***vacancies*** on the board at the moment.

Example: The articles of incorporation of C corporation provide that it shall have a nine-member board. At the time of a particular directors' meeting, there are two vacancies. A quorum consists of five, not four, board members, since there must be a majority of the total number of seats, not the number of sitting directors.

b. Variable board: But if the articles set up a ***variable-size*** board (see *supra*, p. 60), a quorum is generally set as a majority of the directors ***in office*** at the start of the meeting. See, e.g., MBCA §8.24(a)(2).

c. Lesser number: Some states, but probably still a minority, now allow the articles of incorporation or bylaws to specify a percentage that is ***less than a majority*** as the quorum. For instance, both Delaware (§141(b)) and the MBCA (§8.24(b)) allow the articles of incorporation or bylaws to establish any percentage that is ***one-third*** or greater as the quorum.

d. Super-majority as quorum: Conversely, statutes often permit the articles or bylaws to establish a quorum of ***more than a majority***. See, e.g., MBCA §8.24(a). Such a provision could be used as a control device in a closely-held corporation. For instance, the bylaws could be amended to provide that all three directors must be present for a quorum; this way, a minority shareholder who controls one seat could actively block corporate action by refusing to attend directors' meetings.

e. Quorum must be present at time of vote: The quorum must be present ***at the time a vote is taken*** in order for the vote to constitute the act of the board. Thus even if a quorum is present at the start of a meeting, directors may, by leaving, remove the quorum and thereby prevent further board action. (A different rule applies to ***shareholders'*** meetings, at which all that counts is that a quorum be present at the start of the meeting. See *infra*, p. 82.)

f. **Quorum for filling vacancies:** We said just above that the board of directors may not take action unless a quorum is present. There is one exception to this rule: In most states, the board may ***fill a vacancy*** even though less than a quorum of directors is present. Carefully-drafted statutes make it clear that this right exists only where the number of directors ***in office*** is less than a quorum; other statutes leave open the possibility that a vacancy may be filled if less than a quorum is present at the meeting, even though more than a quorum is in office.

Example: Corporation has a board whose fixed size is six directors. A quorum would therefore be four. There are two vacancies at the moment. Under the MBCA, three directors at a "meeting" may not fill the vacancy — the number of directors in office is not less than a quorum, even though the number of directors at the "meeting" is. See MBCA §8.10(a)(3) and Official Comment thereto. But some older statutes might be interpreted to allow the three members to fill the vacancies; see Nutshell, p. 221. Observe that under the MBCA approach, on these facts a single board member could prevent the board from ever taking action; by staying away, he could prevent there ever being a quorum to fill the vacancies; therefore the vacancies could never be filled, so there could never be a quorum for purposes other than election of directors. (Eventually, however, the *shareholders* could fill the vacancies.)

G. **What constitutes act of board:** Normally, the board may take action only by ***vote of a majority of the directors present*** at the meeting. See, e.g., MBCA §8.24(c).

1. **Higher number:** However, many modern statutes allow the articles of incorporation to specify a ***higher percentage*** than a majority for all or certain board actions. For instance, MBCA §8.24(c) allows a higher number to be required by ***either*** the articles of incorporation or the bylaws.

H. **Formalities for board action:** Normally, the board of directors may take action ***only at a meeting***, not by individual action of the directors. Directors, unlike shareholders, ***may not vote by proxy***. Clark, pp. 109-110.

1. **Rationale:** Why should there be a rule that the directors must act during a duly-convened meeting rather than as separate individuals? The traditional rationale for this requirement is that "the decision-making process is likely to function better when the directors consult with and react to one another. A ***group discussion of problems*** is thought to be needed, not just a series of yea or nay responses." Clark, p. 110.

2. **Exceptions to requirement of board meeting:** Under modern statutes there are a few ***exceptions*** to the general rule that directors may act only by duly-convened meeting.

   a. **Unanimous written consent:** First, nearly all states now provide that directors may act without a meeting if they give their ***unanimous written consent*** to the proposed corporate action. See, e.g., MBCA §8.21(a), allowing this unanimous written consent procedure unless the articles of incorporation or bylaws prohibit it. Observe that because the written consents must be unanimous, a ***single director*** who opposes the action can, in effect, require that a meeting be held to discuss the action. Also, note that under this MBCA provision, the consent does not become effective until the ***last director*** has signed the consent; therefore, the consent method ***cannot*** be used as a means of ***ratifying*** a purported corporate action that has taken place before all directors have signed. However, the doctrines of ratification and estoppel discussed *infra*, p. 77, will, if they apply at all, have a retroactive effect in this situation.

   b. **Telephone meetings:** Many states now permit the directors to act by means of a ***telephone conference call***. For instance, MBCA §8.20(b) authorizes the conducting of a meeting by use of "any means of communication by which all directors participating may ***simultaneously hear each other*** during the meeting." This is not really an exception to the requirement of the meeting, but rather a re-definition of what constitutes a "meeting" — the main purpose of a meeting, that board members be able to simultaneously discuss the proposed matter, is of course carried out when the meeting occurs telephonically.

c. **Ratification:** In a sense, the related doctrine of ***ratification***, discussed *infra*, p. 77, may serve as a substitute for a formal vote of the board at a duly-convened meeting. That is, if a corporate officer takes an action without board authorization (e.g., signs a contract), and the board later learns about it but does nothing to undo the action, the corporation will likely be held to have ratified the action, preventing the corporation from claiming that the action took place without board approval.

I. **Objection by director:** A director may sometimes wish to ***disassociate*** herself from action taken by the board, because she feels that the action is unwise, illegal, or a breach of fiduciary duty. It may be quite important for the director to register her dissent, because if she does not do so, she may be personally liable for the board's action even though she remained silent or orally voiced reservations. (See *infra*, p. 171.) Therefore, the director in this situation should either submit a formal ***written*** dissent or abstention, or should make sure that her oral dissent or abstention is ***entered in the minutes*** of the meeting. See MBCA §8.24(d)(2) and (3).

J. **Composition of the board:** Board members of a publicly-held corporation can be thought of as falling into three categories: (1) ***insiders*** (executives or employees of the corporation); (2) ***"quasi-insiders,"*** i.e., people who have some other significant relationship with the corporation or its chief executive (e.g., the corporation's lawyer or investment banker); and (3) true ***"outsiders,"*** i.e., those who do not fall into either of the two previous classes. K&C, p. 126.

1. **Traditional structure:** Traditionally, corporate boards were usually dominated by insiders and quasi-insiders. This structure

was often criticized on the grounds that it led to a board that merely "rubber stamped" management's decisions, rather than acting as a truly independent force.

2. **Modern trend:** Today, especially among the large publicly held corporations, the trend is to have a ***majority of true outsiders*** on the board. For instance, a majority of the boards of most New York Stock Exchange-listed companies is today composed of true outside directors. K&C, p. 126. The ALI's *Principles of Corporate Governance* recommend that even small publicly-held corporations should have at least three directors who are "free of any significant relationship with the corporation's senior executives" (i.e., class (3) above). See §3A.01(b).

K. Committees: Boards increasingly tend to appoint ***committees*** of their members to carry out certain board functions. A committee typically consists of three or more board members, and is given authority to take certain specified action on behalf of the board. The two most common kinds of committees are the ***audit*** and the ***compensation committees***. ***Executive*** and ***nominating*** committees are also frequently appointed.

1. **Rationale:** There are two main rationales for this increasing use of committees: (1) boards, especially those of large publicly-held corporations, are frequently so large as to be unwieldy, and meet too seldom to stay on top of the corporation's affairs; and (2) some kinds of board actions (e.g., compensation of senior executives) are best handled outside the presence of senior management, and therefore are best handled by a committee composed solely of independent directors.

2. **Model Act:** The MBCA demonstrates the modern trend of facilitating the use of committees. §8.25(a) allows the appointment of committees by the board unless the articles of incorporation or the bylaws specifically prohibit them. With a few exceptions, "each committee may exercise the authority of the board of directors.…" §8.25(d).

   a. **Majority of board:** However, a majority of the ***entire sitting***

board must approve the creation of a committee and the appointment of members to it. §8.25(b). That is, it is not enough that a committee is approved by a majority of the directors present at a meeting containing a quorum (the standard for other types of board action; see *supra*, p. 65). This requirement of an absolute majority reflects the serious authority which can be and often is entrusted to committees.

b. Off-limits actions: Under the MBCA, committees are not allowed to take certain very important types of actions. Some of these off-limits actions include: (1) filling vacancies on the board; (2) amending the articles of incorporation or the bylaws; (3) approving or proposing to shareholders actions that require shareholder approval; and (4) authorizing the issuance or re-purchase of shares. §8.25(e). The basic idea behind these limits is to "prohibit delegation of important actions that cannot be overruled or overturned by the board of directors." Nutshell, p. 231.

c. Allowed actions: But even with these limitations, committees can take some very important actions in the name of the board, without separate board approval. For instance, a committee may authorize the corporation to take on ***long-term debt*** or to make a large ***capital investment***; it may set the price at which shares shall be issued (so long as the whole board has approved the issuance); it may ***appoint or remove senior management***, and fix the salary of these executives. See Official Comment to §8.25.

3. Audit committee: Probably the most commonly-encountered committee is the ***audit*** committee. For example, the New York Stock Exchange now requires every listed company to have an audit committee composed entirely of independent directors, and probably most non-NYSE middle-sized and large corporations have also appointed such a committee. See K&C, p. 122. The audit committee typically meets regularly with the corporation's outside ***auditors*** to review the corporation's financial statements and the audit process. *Id.*

a. **Rationale:** The corporation's outside auditors are usually hired (and fired) by senior management. Therefore, without an audit committee, there is a real chance that management will try to conceal its shortcomings by pressuring the auditors to paint an unduly rosy picture of the corporation's performance. Since audit committee meetings take place outside of the presence of management, the independent directors on the committee can ask the kind of embarrassing questions ("Are earnings being properly stated?" "Are there any contingent liabilities which management hasn't told us about?") that directors would probably not ask at a full board meeting. *Id.*

4. **Nominating committee:** A ***nominating*** committee nominates candidates to run for ***vacancies*** on the board of directors. Without a nominating committee composed largely of outsiders, the chief executive will tend to nominate either insiders, quasi-insiders, or "outsiders" who are in fact his close friends and whom he expects to be loyal to him. Therefore, if the board is to be more than a rubber stamp for management decisions, it must get a truly independent cadre of outside directors; the nominating committee furnishes a way to do this. For this reason, a nominating committee should have at least a majority of outside directors. Probably only a minority of publicly-held corporations have formed nominating committees, but the number is growing rapidly. K&C, p. 123. (Regardless of whether it is the CEO or a nominating committee that nominates candidates, these "official" candidates almost always win the election; only in the rare case of a successful "proxy fight" — see *infra*, p. 120 — does someone not nominated by management or the existing board get elected.)

5. **Compensation committee:** Most publicly-held corporations now have a ***compensation*** committee composed principally of outside directors. Such a committee sets the salaries and other compensation of the chief executive and other senior management. Again, the theory (though not necessarily the practice) is that a committee composed of outsiders will be less dominated by the CEO and will thus be more objective (and

stingier) than the full board would be.

6. **Executive committee:** Many companies have an ***executive*** committee, which essentially performs the functions of the board between meetings of the full board. Such a committee is especially common where the full board meets only a few times a year. *Id*. Unlike the three types of committees discussed above, the executive committee is usually composed of insider or quasi-insider members, since they must be available on short notice and be familiar with the daily affairs of the corporation.

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(THE BOARD OF DIRECTORS)*

16. Brady Strippers, Inc., a furniture refinishing company, has two shareholders, Mike Brady and Carol Brady, and three directors, who are elected annually. Mike owns 60 shares of Brady Strippers stock, with Carol owning the other 40 shares. All shares can vote. Mike wants to elect Greg, Peter, and Bobby as directors; Carol wants to elect Marcia, Jan, and Cindy.

(a) You represent Carol. What advice should you give her about what she should do to maximize the number of directors she can elect (and is there any special procedural advice you have for her about how to implement your substantive advice)? ____________________________

(b) If Carol follows your advice in part (a), how many directors is she likely to end up with?

(c) If Carol doesn't follow your advice, what's likely to happen?

____

17. The Heavenly Choir Musical Instrument Company has a board of directors whose number is fixed in the charter at 5. Three of these members are Richie Valens, Janis Joplin and the Big Bopper. The three are killed in a plane crash, leaving just two members (less than a majority of board seats, and thus less than a quorum.) Can the two remaining directors fill the vacancies anyway? ____________________________

18. The Acme Electrical Company — “Let us fix your shorts” — has bylaws providing for regular, quarterly board of directors meetings, which are to take place at the company headquarters on the first Wednesday of each calendar quarter, unless a different time or place is set by prior board resolution. A quorum is three of the five directors. One of the directors is Wile E. Coyote. At the most recent quarterly meeting Coyote was not present, but the other four directors were. At that meeting, the board (by unanimous vote of all present) approved an acquisition. As soon as he found out about the acquisition (2 days after the meeting approving it), Coyote challenged it, stating (accurately) that he did not receive constructive or actual notice of the time and place set for the meeting.

(a) Does the lack of notice to Coyote make the board’s action invalid?

____

(b) What difference, if any, would it make if the meeting had been a special rather than regular quarterly meeting?

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19. Spencer Christian is a member of the board of Pitcairn Travel Agency, Inc. Captain Bligh, another director (and majority stockholder), calls a special meeting of the board of directors to discuss changing the location of the annual meeting from an island in the South Pacific to a town in the Midwest, since this would be far more convenient for the company’s directors and shareholders. Christian doesn’t receive notice of the meeting; however, he happens to be at company headquarters when the meeting starts. He sits in and offers his opinion — he’s hotly against the move. A majority of the directors present vote for it, however. Christian then challenges the change, claiming that the meeting was invalid because he didn’t receive clear and timely notice of it. What result? (Assume that there are no quorum issues.) ______________________________

20. Jack is president of the Fee Fi Fo Produce Company. Undertaking a new crop line is considered major enough to require approval of the board of directors. Nonetheless, Jack is at the Cow Tavern one day when Butcher, another patron, proposes to sell him some “magic beans,” which Butcher claims will produce giant beanstalks. Fee Fi Fo doesn’t plant beans currently. Jack says, “I can’t buy the company unless my board of directors approves.” Several members of the five-person board are out-of-town. So Jack telephones each board member, one at a time, and asks them to approve the transaction. Four say "yes," but the fifth, Giant, says "no." Is Jack authorized to enter the purchase contract?

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21. Same facts as the previous question. Now, however, assume that all five directors say "yes."

(a) What procedural step can Jack take to implement the action without a formal board meeting at which a quorum is present?

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(b) Would your answer to part (a) work if Giant persisted in saying "no" to the proposed acquisition, while the other four directors said "yes"? ____________________________

22. Benedict Arnold is a member of the Libber Tea Company board of directors. He has two years left on his board term. The company does not have cumulative voting. George III, Libber Tea's majority shareholder, sells his interest to George Washington. At the next annual shareholders' meeting, Washington says (to everyone's surprise), "I now move to remove Arnold from the board of directors." Washington does not give any reason in support of his desire to remove Arnold. The motion is duly seconded. All shareholders but Washington vote against the motion (i.e., vote to keep Arnold), but since Washington owns a majority of the shares the motion passes. The jurisdiction has enacted the MBCA. Libber's articles of incorporation are silent on the issue of removal of directors.

(a) Putting aside any issues of notice, was Arnold validly removed from the board? ____________________________

(b) Now, focusing solely on the issue of notice, was Arnold's removal handled properly? ____________________________

(c) Would your answer to part (a) be different in a jurisdiction that follows the traditional common-law approach to removal of directors?

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23. Melmac Phlegm Industries, Inc., has a board of directors with five members. The corporation's charter authorizes cumulative voting. Alf is elected to the board. He's not an especially impressive board member (he makes off-the-wall comments and rarely says anything intelligent), but he doesn’t do or say anything that would be cause for removal in the jurisdiction. Two major stockholders duly call a special stockholders meeting for the stated purpose of removing Alf from the board. By a vote of 1,000 to 800, the shareholders vote to remove Alf, even though his term has one year left to run. Has Alf been validly removed from the board? ____________________________

Answers

16. (a) You should tell her to use cumulative voting. Of course, depending on the state and on what the company’s charter says, Carol may not be able to bring this about on her own. (For instance, MBCA §7.28(b) allows cumulative voting only if the charter explicitly includes it; if Brady Strippers’ charter doesn’t, then without Mike’s agreement Carol can’t get the charter amended and thus can’t use cumulative voting.)

You should also tell Carol to give *advance notice* to Mike that she’ll be voting cumulatively, if you’re in a jurisdiction that requires such advance notice. See, e.g., MBCA §7.28(d), so requiring.

(b) She’ll elect one director. Under cumulative voting, there’s no limit on how many shares a shareholder can use for any one candidate. The number of shares needed to elect *n* directors is determined by the formula

$$\frac{nS}{D+1}+1$$

where *S* is the total number of shares voting and *D* is the number of directors to be elected. So to elect one director, Carol would need 26 shares ((100 total shares ÷ 4) + 1). Since she’s got 40 shares (120 votes), she’ll be able to do this. She’ll want to cast at 61 of her votes for her favorite candidate, let’s say Marcia. That way, even if Mike spreads his votes evenly (which is how he comes closest to being able to elect all three of his candidates), he’ll have only 60 votes for each, so Marcia will finish first, and one of his 3 will then lose to the other 2 in a run-off election. (If he splits his votes any other way, Marcia will finish third, and will take the third seat.)

(c) She won’t elect any directors. With straight voting, a shareholder cannot cast, for any single candidate, more votes than the voter owns shares. Thus, in straight voting, although Carol gets 120 total votes, she can't cast more than 40 of them for any single candidate. Mike is, similarly, limited to 60 votes for any candidate. Therefore, the voting will be: Greg, Peter and Bobby, 60 each, Marcia, Jan and Cindy, 40 each, and Greg, Peter and Bobby will be elected.

17. **In most states, yes — even though they don't constitute a quorum.** Normally, a board election to fill a board vacancy is like any other board action — it must occur at a meeting at which a quorum is present. But to deal with the situation presented in this question, most states recognize an exception: when the number of directors remaining in office is less than a quorum, each vacancy can be filled by a majority vote of the remaining directors. [64] So in such a state, any candidate who got the vote of both of the remaining directors (i.e., a "majority" of the 2 remaining directors) would be elected. See, e.g., MBCA §8.10(a)(3).

18. **(a) No — The business transacted at the meeting was valid.** As a general rule, the board of directors may only take action at a properly convened meeting. The two prerequisites of a properly convened meeting are quorum and notice. The issue here is notice. The general rule is that "regular" meetings — i.e., those whose time and place are fixed by the bylaws or prior resolution — don't require notice of time and place. [63] See, e.g., MBCA §8.22(a) ("Unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place or purpose of the meeting.") On these facts, the quarterly meetings are provided for in the bylaws. As a result, business at the meeting was valid, even though Wile E. didn't receive particular notice of it.

    (b) The meeting would probably be invalid. Most states *do* require that notice of time and place be given to each director for a "special" meeting, i.e., one which is not a "regular" (e.g., quarterly) one. See, e.g., MBCA §8.22(b) (at least 2 days advance notice of time and place required for a special board meeting.) [63]

19. **The meeting was valid, because Christian waived the notice requirement.** As the prior answer says, for "special" meetings — i.e., those whose time is not fixed by the bylaws or prior resolution — all

directors must receive clear and timely notice of the meetings (which includes the date, time, and place of the meeting). Here, Christian didn't receive notice, so if he hadn't attended a court would allow him to challenge the board action.

However, Christian waived the requirement by showing up at the meeting and not making a prompt objection to the lack of notice. See, e.g., MBCA §8.23(b) ("A director's attendance at or participation in a meeting waives any required notice to him of the meeting unless the director at the beginning of the meeting (or promptly upon his arrival) objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.") [63] Therefore, the vote was valid.

20. **No.** Board action may generally occur only at a duly-noticed board meeting, at which a quorum is present. Most states now treat a director as being "present" if he's part of a telephone conference call. But this "exception" to the requirement of a quorum applies only if enough board members to constitute a quorum are all *simultaneously* on the phone, because the purpose is for them to all be able to discuss the matter at once and receive input from each other. The seriatim phone calls here did not satisfy this requirement. Therefore, no quorum was present, and consequently board action has not occurred. Since the facts say that undertaking a new crop line requires board approval, Jack can't proceed. (If Jack goes ahead anyway and plants the seeds, then the doctrine of "ratification" may apply. [77])

21. **(a) Have them sign a unanimous consent to the purchase.** Nearly all states now provide that directors may act without a meeting if they give their unanimous written consent to the proposed corporate action. See, e.g., MBCA §8.21(a). So all should sign copies of a resolution saying that the board approves the purchase.

(b) No. For the "written consent" exception to work, the written consent must be ***unanimous***. Thus Giant, by refusing to sign, can force Jack to call a formal board meeting at which a quorum is present. That way, Giant will get to make his arguments in person to the other directors — he may get outvoted, but he's guaranteed a chance to speak against the action.

22. **(a) Yes.** Under the MBCA, as in most states today, shareholders can (by ordinary majority vote) remove a director from office at any time, without cause. See MBCA, §8.08(a). (This rule does not apply if the articles of incorporation say that directors may be removed only for cause, but the facts tell us that Libber's charter is silent on this point.) Thus the holders' action here sufficed to remove Arnold even though no cause (like fraud, or gross abuse of discretion) was shown. [61]

Observe that this very scenario — change of control — is the scenario in which the ability to remove a director without cause is of greatest importance. Without such an ability, Washington would have to wait until the expiration of Arnold's term, two years from now, before he would have full control of the board. And, in fact, if a majority of the board were friendly with George III and had the same two years to run, then Washington wouldn't be able to exercise any control over the company for two years even though he was the majority owner! So the power of removal-without-cause by vote of a majority of shareholders is very important to merger-and-acquisition law.

(b) No. Under MBCA, §8.08(d), "A director may be removed by the shareholders only at a meeting called for the purpose of removing him and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director." Since the facts suggest (by the reference to "everyone's surprise") that the notice of meeting did not mention that Arnold's removal would be a purpose of the meeting, the vote was improper. [62] (But Washington could fix the problem at any time, at least under the MBCA. As a more-than-10% owner, he could call a special meeting of shareholders at any time under MBCA §7.02(a)(2), and state that the purpose was to vote on whether Arnold should be removed. [80] Then, he could cast his votes in favor of the motion and remove Arnold.)

(c) Yes. At common law, directors were only removable for cause; that is, for conduct harmful to the corporation, like fraud, incompetence, or disloyalty. Thus under the traditional rule, Arnold could successfully challenge his removal.

23. **No.** The fact that cumulative voting is authorized by the corporation makes all the difference. In virtually all jurisdictions, if the corporation

has authorized cumulative voting, a director cannot be removed without cause if there are cast against his removal enough votes to have elected him under cumulative voting. (If this were not the rule, the majority could always remove minority-chosen directors, defeating the whole purpose of cumulative voting.) [62] See, e.g., MBCA §8.08(c). Here, there were 1800 shares voting, and the board has 5 seats. Therefore, by the formula for the number of shares which one must control in order to elect one director (further explained in the answer to question 15):

$$\frac{S}{D+1}+1 \ ,$$

Alf could have been elected so long as at least the following number of shares voted for him:

$$\frac{1800}{6}+1= \ 301$$

Since the 800 shares voted against Alf's removal were more than 301, Alf got enough support to have elected him to the board, so he won't be deemed to have been removed. (If the corporation had not authorized cumulative voting, then the analysis would be like that in the prior question, and Alf would be deemed removed by simple majority of those voting.)

III. OFFICERS

A. Meaning of "officer": The term ***"officer"*** is usually used to describe only the more important executives in the corporation. Clark, p. 114. Typically, the term is used to describe those executives who are ***appointed directly by the board of directors***. *Id.*

1. Names of posts: Most older statutes specify the particular officerships that a corporation must have. For instance, many statutes require that there be a president, one or more vice-presidents, a treasurer, and a secretary.

a. Model Act and Delaware: But the modern trend is ***not*** to require specific named positions. For instance, both the MBCA and Delaware leave it up to the bylaws or to the board to determine what officers there shall be. See MBCA, §8.40(a); Del. GCL §142(a).

2. **Multiple posts for one person:** Whether or not the statute requires certain named officers, nearly all statutes allow one person to hold ***multiple officerships simultaneously***. In a closely-held corporation, for instance, the president will also commonly be the treasurer.

   a. **Exception for secretary:** The one exception is that the ***president*** and ***secretary*** are usually ***not*** permitted to be the ***same*** person. The reason is that the secretary's principal function is to certify that a person signing a document as chief executive officer is in fact that person; it would make little sense to allow *A* in his role as secretary to certify that he, *A*, is in fact the president/CEO — "an imposter would happily certify these facts." K&C, p. 124.

B. **Right to hire and remove:** The board of directors has not only the power to appoint officers, but also the power to ***remove them***, with or without cause. This is true even though the officer has an employment contract that is still in force — the board has authority to fire the officer, but he in turn has the right to sue the corporation for damages (but not the right to specific performance, i.e., the right to be reinstated).

C. **Authority to act for corporation:** Recall that, under the traditional view, the corporation is managed by the board of directors, not by the officers (*supra*, p. 50). Therefore, even when an officer ***purports to act on behalf of the corporation*** and to bind the corporation, his action ***may not be legally sufficient to bind the corporation***. Since the officer is an ***agent*** of his principal (the corporation), the officer's authority to bind his principal is usually analyzed by use of traditional ***agency principles***.

1. **Not automatically binding:** The most important concept to keep in mind is that an officer (even the president) ***will not automatically have authority*** to bind the corporation to a transaction merely by virtue of his office. Only if one of the doctrines described below applies will the corporation be bound

by the act of its officer.

Example: Brown, the treasurer of ABC Corp., promises Gray that ABC will guarantee a debt owed by Black to Gray. The mere fact that Brown is ABC Corp.'s treasurer does not give him authority to bind ABC. Therefore, unless Gray can show that Brown had express authority, implied actual authority, or apparent authority to bind ABC, or that the board subsequently ratified the guarantee (the four doctrines described below), Brown's action will not cause the corporation to be bound to honor the guarantee, even if Brown honestly believes that he had authority to bind the corporation, and even if Gray honestly believed Brown's statement that he, Brown, had authority.

2. **Four doctrines:** There are four doctrines commonly used to hold that the officer has bound the corporation: (1) ***express*** actual authority; (2) ***implied actual*** authority; (3) ***apparent*** authority; and (4) ***ratification***. We will consider each of these in turn.

3. **Express actual authority:** ***Express actual authority*** is the easiest concept to understand. Usually, this comes into existence by an explicit grant of authority to the officer to act on behalf of the corporation. This explicit grant generally comes from either the corporation's ***bylaws***, or in the form of a ***resolution*** adopted by the board of directors.

Example: The board adopts a resolution authorizing the Vice President to negotiate and sign a contract to dispose of one of the corporation's surplus plants. This board resolution constitutes a grant of express authority to the Vice President. Therefore, when he signs the contract on the corporation's behalf, the corporation will be bound, even if it is not usually the case (either generally or in this particular corporation) that vice presidents may sign contracts to sell plants.

4. **Implied actual authority:** The doctrine of "***implied*** actual authority" is a much fuzzier one. It is often described as "authority which is ***inherent in the office.***" Clark, p. 115. There

are two common ways in which implied actual authority can come into existence:

a. **Inherent in post:** First, authority may be ***inherent*** in the particular ***post*** occupied by the officer, measured by the ***common understandings of business people***.

   Example: It is today commonly assumed that the president of a corporation has actual authority to sign at least non-extraordinary contracts (e.g., contracts for the corporation to receive supplies that it needs in the ordinary course of its business). Therefore, if President signs such a supply contract on behalf of Corporation, the court would probably hold that President had implied actual authority to bind Corporation to this contract, even though the board of directors never specifically authorized him to sign either this particular contract or any similar contract — authority to sign such contracts is simply found to be inherent in the presidency of a corporation.

b. **Particular action of board:** Second, the board, by its own ***conduct or inaction***, may have ***implicitly*** granted the actual authority to the officer in question. Thus even if vice presidents in the business world are generally not permitted to sign contracts disposing of surplus plants, the fact that ABC's Corp's board has allowed Vice President to do so in the past without objection, or the fact that the board has known that Vice President was about to sign the particular contract in question, would be enough to clothe Vice President with implied actual authority to sign the present contract on behalf of ABC.

c. **Particular posts:** There has been a lot of litigation about the inherent power of various corporate posts, especially the presidency.

   i. **Presidency:** Traditionally, the ***president*** had little if any authority to bind the corporation merely by virtue of his office. However, this narrow view conflicted with what most non-lawyers thought the president could do.

Therefore, the modern trend is to treat the president as having, by mere virtue of his position, at least the authority to bind the corporation in ***ordinary business transactions***. H&A, p. 596.

(1) Illustration: Thus most courts today would probably hold that the president has implied authority, by virtue of his office, to ***hire and fire*** non-officer-level employees; and the authority to enter into ***ordinary-course contracts*** (e.g., contracts to supply the business' ordinary raw materials requirements, or to sell part of the corporation's output).

(2) Beyond the scope: But other kinds of actions would, even under the more expansive modern rule, probably be found to be ***"extraordinary"*** and thus ***not authorized*** by the president's office alone: ***lifetime employment contracts***; contracts to sell, lease or mortgage ***real estate***; contracts to sell all of the corporation's ***assets***; contracts to issue and distribute ***new stock***; and agreements to ***settle*** important litigation.

See generally Clark, p. 116; Nutshell, p. 238.

ii. Chairman of the board: There is no generally accepted rule about the inherent authority of the ***chairman of the board***. The scope of this post varies dramatically from corporation to corporation — in some companies this post is held by the chief executive officer (with the president being the chief operating officer, or number two executive); in other cases the chairman is largely an honorary figure, who is not the C.E.O. In general, it is not safe to assume that the chairman has ***any*** inherent authority by virtue solely of his position. C&E, p. 302-03.

iii. Vice president; treasurer: A ***vice president*** or a ***treasurer*** probably has little if any authority by virtue of his or her position. However, if a vice president has the appearance of standing close to the top of the corporate hierarchy, (e.g., an Executive Vice President), he may under the modern, looser, approach to authority be held to have some limited authority in ordinary-course matters. *Id*.

iv. **Secretary:** The ***secretary*** has one key element of inherent authority in virtually every jurisdiction: He has inherent authority to ***certify the records of the corporation***, including ***resolutions*** of the board of directors. Therefore, a secretary's certificate that a given resolution was duly adopted by the board is ***binding*** on the corporation in favor of a ***third party who relies on the certificate***. C&E, p. 303-04. (But the secretary has no other inherent authority to bind the corporation.)

5. **Apparent authority:** A third way in which the officer may bind the corporation is by the doctrine of ***apparent authority***. Under this doctrine, when the actions of a ***principal*** (the ***corporation***) give the ***appearance to reasonable persons*** that the agent is authorized to act as he is acting, the principal is held responsible for creating the impression that the agent had actual authority to act; therefore, the principal may not avoid the transaction. K&C, p. 123.

a. **Requirements:** Thus for the third party to successfully invoke the apparent authority doctrine, he will have to show that: (1) the ***corporation***, by acts ***other than those of the officer***, ***indicated to the world*** that the officer had authority to do the act in question; *and* (2) the plaintiff was ***aware*** of those corporate indications and relied on them. K&C, pp. 123-24.

b. **Mere position as source of apparent authority:** Sometimes, the plaintiff will be able to point to specific, affirmative conduct by the corporation that indicates to the world that the officer has the authority in question. For instance, if the board of directors is aware that Vice President has routinely been signing large contracts to buy raw materials, and the board does not object, a supplier who can show this past pattern of acquiescence (and who can show he was aware of it at the time of his own contract) would probably succeed in arguing that Vice President had apparent authority. But often, the mere ***post*** held by the officer, when coupled with ***industry practice***, will be enough to create apparent authority. This is most likely to happen where the action is by the company's president, and the action is of a sort that presidents are usually permitted to take.

Example: The board of directors of Corporation appoints Smith as president. Because the chairman's son has long held the post of vice president for Office Supplies, Smith is handed a board resolution expressly denying that Smith has any authority whatsoever to purchase office supplies for Corporation. Nonetheless, Smith, introducing himself to Supplier as president of Corporation, orders office supplies. Supplier does not know of the special limitation on Smith's authority.

Assume (as is probably the case) that by custom, a person holding the title of president will in most corporations have actual authority to order office supplies. If so, Supplier will probably be able to bind Corporation to the contract Smith signed with him, on an apparent authority theory. The board of directors, by clothing Smith with the title of "president," has indicated to the world that Smith has the authority usually found in that post. If the board wishes to deny Smith that authority, it must bear the burden of ***communicating to the world*** (including to Supplier) that Smith does not have this customary presidential authority. Observe that on these facts, Corporation is bound under the apparent authority doctrine even though it is absolutely clear that Smith did not have any kind of actual authority (not even implied actual authority) because of the resolution. See Clark, p. 117.

c. Representation by agent: For the apparent authority doctrine to apply, it is ***not*** sufficient that the ***agent himself*** represents to the third party that he has authority to enter into the transaction. The indications of authority must come from ***someone else*** in a position of power at the corporation. Thus if Vice President tells Supplier "I have full authority to contract for the purchase of office supplies," this representation does not create apparent authority, since Supplier should know that Vice President may simply be lying or mistaken about the degree of his authority. (If, on the other hand, the board of directors had appointed him with the title Vice President of Supplies and given him a business card with that title, a person who saw and relied on the card would probably succeed in establishing apparent authority.)

d. The president and "ordinary-course" transactions: As we saw in the example involving Smith and the supplies, *supra,* the mere fact that an officer has been given a common title (e.g., president) will itself be enough to give him apparent authority to do certain transactions. In the case of an officer bearing the title of president, the usual modern rule is that the president has apparent authority "to take actions in the ***ordinary course*** of business, but ***not extraordinary*** actions." C&E, p. 300-01. But where is the line between "extraordinary" and "ordinary"? "A useful generalization is that decisions that would make a ***significant change*** in the ***structure*** of the business enterprise, or the structure of ***control*** over the enterprise, are extraordinary corporate actions and therefore normally outside the president's apparent authority." C&E, p. 301-02.

i. Illustrations: Thus the ***issuance or re-purchase*** of ***shares*** by the corporation, the taking on of significant ***debt***, the making of significant ***capital investments***, the ***sale*** of one of the corporation's ***significant businesses***, or its entry into an important ***new line of business***, would all be "extraordinary" (and thus not within the president's apparent authority) in most circumstances. *Id.*

ii. Comparison with implied actual authority: Observe that a similar "extraordinary vs. ordinary" test is also used to determine whether the president has ***implied actual*** authority to take a particular action. (See *supra*, p. 74.) But even though a given act by a president will often indicate that he has both implied actual authority (by virtue of his position) and apparent authority, the two doctrines are not the same. Implied actual authority can always be negated by an express board resolution to the contrary (as in the Smith office-supplies example *supra*, p. 75); but the board cannot negate apparent authority unless it communicates this fact to the third person who is relying.

e. Question of fact: In the final analysis, it will often be a ***question of fact*** for the jury whether, taking into account all the circumstances, the officer had apparent authority to do the act in question. That is, there are many situations that are so close to the blurry line between "extraordinary" and "ordinary course" transactions that it cannot be said as a matter of law that the transaction falls into the one class or the other.

6. Ratification: Suppose that at the time an officer acts on behalf of the corporation, he has neither actual nor apparent authority. The corporation may nonetheless be bound by its ***subsequent*** actions, under the doctrine of ***"ratification."*** Under this doctrine, if a person with actual authority to enter into the transaction ***learns*** of the transaction and either expressly ***affirms*** it or even ***fails to disavow it***, the court may find that the corporation is bound.

a. Retention of benefits or reliance by third party: In most of the cases where the ratification doctrine is applied, either or both of two special factors is present: (1) the corporation has ***received benefits*** under the contract, which it has not returned; or (2) the third party has ***relied to his detriment*** on the existence of the contract. Nutshell, p. 240. However, strictly speaking the mere after-the-fact approval or acquiescence of the board ought to suffice, even without either of these two special factors.

b. Full knowledge by board: Of course, the plaintiff who is claiming ratification must show that the ratifier had ***full knowledge*** of the contract. For instance, if the board knows that the president has signed a contract to acquire a company from X, but does not know that the president is receiving a kickback from X or does not know that the contract calls for the corporation to pay a very excessive price, a court would probably not find that the board’s mere failure to object constituted ratification.

7. **A “bullet-proof” means of confirming authority:** The above discussion demonstrates that authority is a tricky concept — a third party will often find it hard to be certain that the corporation officer he is dealing with really has authority to bind the corporation to the proposed transaction. However, there is one “bullet-proof” way in which a third party can be certain that the corporation will be bound: He should “require the person purporting to act for the corporation to deliver, prior to the closing of the transaction, a ***certified copy*** of a ***resolution*** of the board of directors authorizing the transaction in question or directing the named officer to enter into the transaction on behalf of the corporation. The certificate should be ***executed*** by the ***secretary*** or an assistant secretary of the corporation, the corporate seal should be affixed, and the certificate should recite the date of the meeting (or a statement that the resolution was approved by unanimous written consent) and quote the resolution itself.” Nutshell, p. 237.

   a. **Rationale:** The reason that such a certificate is binding on the corporation is that, in all states, the corporation is ***estopped*** to deny the correctness of its secretary’s certification that a particular resolution was adopted by the board.

Quiz Yourself on
THE CORPORATE STRUCTURE *(OFFICERS)*

24. Frontier Foods, Inc., appoints Betty Crockett treasurer of the corporation, with the express authority to handle corporate funds, and no express authority to do anything else. However, whenever the other officers and employees have their hands full, Betty steps in and helps out by purchasing inventory on the corporation’s behalf. She’s purchased hardtack for Frontier Foods from the Tuffas Leather Company several times before, and Frontier has always paid the invoices. Betty now makes out a new purchase order for fifty cases of hardtack, and Tuffas manufactures her order. Before it's delivered, some board members find out that they can get a much better deal on hardtack from a competitor. They try to cancel Betty's hardtack purchase order, claiming that it was unauthorized. Is the purchase order a valid corporate obligation? Cite the doctrines you use in arriving at your answer.

____

25. Dr. Seuss is the corporate secretary for the Sam I Am Company. The company's office manager usually handles the arrangements for the annual meeting of shareholders, and has the express authority to make all necessary contracts regarding the arrangements for the meeting; however, this year the office manager, Bartholomew, has an oobleck virus and can't set up the meeting. Dr. Seuss steps into the void. He looks through the yellow pages and hires the Cat N. Hat Caterers to provide two hundred servings of green eggs and ham.

(a) Assume that the meeting takes place as scheduled. At the meeting, the directors, officers, and shareholders all eat the green eggs and ham. When Cat N. Hat sends its bill, Sam I Am refuses to pay, claiming that Dr. Seuss, as corporate secretary, had no power to bind the corporation. What result? (Cite any relevant doctrines.)

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(b) Assume for this part only that before the meeting, Cat N. Hat sent a document marked "Confirmation," in which he said, "This confirms that we will supply 200 svgs, green eggs & ham, to your annual meeting on 6/14/13." The confirmation is marked, "Attn: President," and the President in fact sees it. He does nothing for two weeks, during which time Cat N. Hat makes substantial preparations (e.g., he makes a special purchase of green eggs.) Three days before the meeting, the President sends a letter to Cat: "The catering order was submitted to you by Dr. Seuss, acting without proper authority. Consider it rescinded." Can Cat hold Sam I Am to the contract (as opposed to merely recovering in quantum meruit for services already performed)?

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Answers

24. Yes, on either an“implied actual authority” or “apparent authority” theory. The issue here is whether Betty had authority to bind the corporation. Officers can bind the corporation only if they act within the scope of their corporate authority (unless the corporation subsequently ratifies the officer’s action, something that’s not relevant to this problem.) There are four types of authority commonly recognized: (1) express actual authority; (2) implied actual authority; (3) apparent authority; and (4) ratification. Here, Betty probably had both “implied actual authority” and “apparent authority.”

An officer has “implied actual authority” whenever either: (1) authority is inherent in the particular post occupied by the officer, measured by common business understandings about what people holding that post customarily do; or (2) the corporation, by its own conduct or inaction, has implicitly granted the actual authority to the officer in question. [74] The situation here falls into case (2), because when the corporation on prior occasions allowed Betty to place purchase orders and uncomplainingly paid the bill, the corporation was implicitly giving her actual authority to place such orders. So even if Tuffas hadn’t been aware that it was Betty who had placed the prior orders, Frontier would still be bound because it gave Betty implied actual authority.

An officer has “apparent authority” when the corporation indicates to a third person that the officer has authority to act on its behalf, and the third person believes in good faith that such authority exists (whether or not it actually does). [75] So Betty had apparent authority to place the order for hardtack, since Tuffas knew that Betty had placed prior orders with it that the corporation had honored. Therefore, even if Frontier now wishes to change its mind about Betty’s authority (or had, unbeknownst to Tuffas, changed its mind before the latest order), Frontier is stuck under the apparent-authority doctrine, because the only issue is what Tuffas reasonably *believed* about Betty’s authority, and Tuffas clearly had grounds to believe that Betty’s purchase was authorized. (Remember, by the way, that for apparent-authority to apply, the corporation itself, not just the agent, must convey to the third person that the agent has authority. So if there had been no prior orders, and Betty had merely told Tuffas, “I have authority to buy,” this would not suffice for apparent authority. It’s the corporation’s acquiescence in the prior orders by Betty that makes the difference here.)

25. **(a) Sam I Am is liable, on grounds of ratification.** The issue here is a corporate officer's ability to bind the corporation. As a general rule, corporate secretaries by virtue of their post alone have no authority to bind a corporation, certainly not to a purchase order. (In other words, Seuss had no express authority or implied actual authority at the moment he acted, nor did he have apparent authority.) However, even though an act is unauthorized at the moment it occurs, it can become authorized after the fact, if the requirements for "ratification" are met. Ratification occurs when the corporation either expressly adopts the unauthorized act (e.g., by passing an explicit resolution adopting the act) or implicitly indicates, by conduct or inaction, that it approves of the action. [77] The most common way in which a corporation implicitly indicates its approval after the fact is by retaining the benefits from the transaction. Here, by allowing its employees to attend the event and eat the green eggs and ham, Sam I Am implicitly ratified the contract. Therefore, the company is liable.

    (b) Yes; the company is nonetheless bound. Again, the doctrine of ratification applies. A company can ratify an otherwise-unauthorized act not just by retaining the benefits, but even by remaining silent after learning of the proposed transaction. [77] Such "silent ratification" is especially likely to be found where the other party relies to his detriment on the proposed transaction, while the corporation is remaining silent. So when the President (who by his post clearly had authority to enter into the transaction in the first place or to ratify it later), remained silent for two weeks during which time Cat was relying (purchasing special eggs, etc.), this would constitute ratification even before the affair occurred.

IV. FORMALITIES FOR SHAREHOLDER ACTION

A. Generally: We examine now some of the mechanics by which ***shareholders exercise their right to vote*** on certain aspects of the corporation's affairs. In particular, we examine: (1) the giving of notice of a shareholders' meeting; (2) the quorum for such a meeting; and (3) the method of voting at such a meeting.

B. Annual vs. special meeting: Nearly all states require a corporation to hold an ***annual meeting*** of shareholders. See, e.g., MBCA §7.01(a). Corporations may also hold a ***"special"*** shareholders' meeting; a special meeting is any meeting other than the regularly-scheduled annual meeting. See MBCA §7.02(a).

1. **No penalty for failure to hold annual meeting:** If the corporation fails to hold an annual meeting, this failure does ***not*** make the corporation's subsequent actions invalid. See MBCA §7.01(c). However, if the annual meeting is not held when scheduled, a shareholder will probably be able to get a court to ***order*** that one be held. See e.g., MBCA §7.03(a)(1) (meeting will be ordered by court on application of any shareholder if meeting has not been held six months after the end of the corporation's fiscal year or fifteen months after its last annual meeting, whichever comes first.)

2. **Purpose of annual meeting:** The purpose of an annual meeting always includes at least the ***election of directors***. (See *supra*, p. 51.) However, the annual meeting may also consider any other relevant issue. According to most statutes, any other issue may be considered even if the issue was not specifically referred to in the ***notice*** given to shareholders. See e.g., MBCA §7.05(b) (notice of annual meeting "need not include a description of the purpose or purposes for which the meeting is called.")

3. **Purpose of special meeting:** A ***special*** meeting is normally called to consider one or a small number of very important matters that cannot wait until the next annual meeting. Unlike the notice of an annual meeting, the notice of the special meeting must ***state the particular issues*** to be raised at the meeting, and no other issues may be considered. See MBCA §7.05(c) and §7.02(d).

4. **Who may call a special meeting:** Statutes vary as to ***who may call*** a special meeting. Such a meeting may always be called by the board of directors. Also, any person or group who is authorized by the ***bylaws*** to call a meeting (e.g., the president,

under many bylaws) may do so.

a. Called by shareholders: Also, some (but by no means all) states allow the holders of a certain ***percentage*** of the ***shares*** to call a special meeting. The MBCA goes especially far in this respect: Under §7.02(a)(2) the holders of a mere ***ten percent*** of the shares may cause a special meeting to be held. By contrast, Delaware does ***not*** allow even a larger percentage of shareholders to call a special meeting; only the board or persons authorized in the bylaws may do so; see Del. GCL §211(d).

i. Raider: Observe that the MBCA approach gives a ***raider*** (i.e., a person attempting a hostile takeover) important powers: If he gains control of a majority of the shares shortly after an annual meeting, he may call a special meeting, ***remove a majority of the existing directors without cause***, and elect his own slate. Under the Delaware approach, by contrast, he probably has to wait until the next annual meeting to gain a majority of the board. (But in Delaware, the raider could probably accomplish the same result by use of Delaware's unusual provision allowing action to be taken by a non-unanimous majority of shareholders based on their written consent; see *infra*, p. 82.)

C. Quorum: Statutes generally require that a ***quorum*** be present at the shareholders' meeting equal to a ***majority of the outstanding shares***. However, the percentage required for a quorum may be ***reduced*** as provided in the articles of incorporation or bylaws.

1. Minimum: However, many statutes set a minimum percentage below which not even the articles or bylaws may set the quorum. Many of these require that at least ***one-third*** of the shares be present as the minimum allowable quorum. See, e.g., Del. GCL §216, setting this one-third figure. But the MBCA makes the articles' or bylaws' minimum quorum provision effective ***no matter how low it is***. See MBCA §7.25(a).

2. Higher numbers: Conversely, nearly all states allow the articles or bylaws to set a ***higher*** percentage as the quorum. This is frequently used as a control device in closely-held corporations; for instance, the articles might require ***all*** shares in a close corporation to be present, as a way of letting the minority shareholder veto action of which he disapproves. Nutshell, p. 177.

D. Vote required for approval: Once a quorum is present, the traditional rule is that the shareholders will be deemed to have approved of the proposed action only if a majority of the ***shares actually present*** vote in ***favor*** of the proposed action.

1. Explanation: Observe that this rule contains two important sub-rules: (1) only a majority of the shares ***present***, not a majority of the total shares eligible to vote, must support the proposal being voted on; and (2) a majority of the shares present must ***affirmatively vote in favor*** of the proposal; that is, an ***abstention*** is the equivalent of a vote against.

a. MBCA changes rule: The MBCA ***changes*** the traditional rule with respect to (2), by making abstentions the same as votes that are not cast. §7.25(c) provides that action on a matter “is approved if the votes cast … favoring the action exceed the votes cast opposing the action.…”

Example: Corporation has 1000 shares outstanding. 600 shares are represented at the meeting (a quorum is, of course, 501, assuming that the articles and bylaws do not set a different number). The vote on an action is 280 in favor, 225 opposed and 95 abstaining. Under the traditional approach, the proposal fails, since it needed 301 votes (a majority of the shares present). But under the MBCA, the action is approved 280-225. See Official Comment to §7.25(c); see also Nutshell, p. 178.

b. Election of directors: The rules for elections of ***directors*** are different from the rules for all other action by shareholders. These director-election rules are discussed in detail *supra*, p. 55. Most importantly, a minority of shareholders will frequently be able to elect one or more members of the board of directors, because of the use of cumulative voting. (Cumulative voting does not apply to shareholder approval of matters other than the election of directors.)

c. **Super-majority for fundamental changes:** Also, the standard rule that a majority is enough to constitute approval does ***not*** apply to certain issues that are of ***"fundamental"*** importance. Most states now allow the articles or bylaws to set a ***higher percentage*** as the minimum percentage needed to approve any given transaction, and many corporations have instituted such higher requirements for fundamental transactions like mergers. Indeed, a "super-majority" voting requirement before the corporation can be acquired by another corporation is a common anti-takeover device today. See *infra*, p. 451.

2. **Breaking of quorum:** Recall that a quorum of directors is required ***throughout*** the directors' meeting. (*supra*, p. 64.) A comparable rule does ***not*** apply to shareholders' meetings. Once a quorum is present at the beginning of the meeting, the quorum is deemed to exist for the rest of the meeting, even if so many shareholders ***leave the meeting*** that the total number present would be less than the number needed for the quorum. See e.g., MBCA §7.25(b) ("[O]nce a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless a new record date is or must be set for that adjourned meeting.") Thus if a minority block knows that its presence is required for a quorum, and fears that a proposal it opposes will be passed, it should not attend the meeting at all rather than attending and leaving before the vote on the issue. Nutshell, pp. 178-79.

3. **Written consent:** Just as directors may act by unanimous written consent (see *supra*, p. 65), so nearly all states allow ***shareholders*** to act by ***unanimous written consent*** without a meeting. Such a provision is especially useful in closely-held corporations, where the few shareholders are in agreement, and the holders do not want to waste time on a formal meeting.

Nutshell, p. 179.

a. **Written consent by less-than-majority:** Furthermore, about a dozen states now allow shareholder approval in the form of written consent by the number of votes needed to approve the action, even if this is ***non-unanimous***. See, e.g., Delaware GCL §228(a). Thus in Delaware for ordinary corporate action requiring approval by a majority of the shares, if the holders of a majority sign a written consent to the action, the action will be binding without a meeting, and the minority shareholders will not have the right to dissent publicly at a meeting. (This trend contrasts with the practice as to directors' meetings, where virtually all states require that the directors must either meet or consent unanimously (*supra*, p. 65).)

i. **Use in takeovers:** Observe that allowing shareholder action to be taken by written majority consent may help a ***raider***: Once the raider acquires a majority of the target's shares, he can carry out shareholder approval of any action needing a mere majority without having to convince the board to hold a special meeting of shareholders. See Nutshell, p. 179.

4. **Meeting in cyberspace:** Traditionally, shareholders have had to be ***physically present*** at the shareholders' meeting in order to count towards a quorum, and to vote. (Unanimous written consent, *supra*, has been the one exception to this rule.) But recently, some jurisdictions have allowed for shareholders meetings to take place ***electronically***, such as via the Internet. For instance, in Delaware the board may authorize shareholders to participate in a meeting "by means of ***remote communication***" and to vote by that same means. Del. G. C. L. §211(a)(2). What Delaware has in mind is a ***"meeting by website,"*** in which shareholders log in, prove that they are authorized, "hear" the proceedings, and vote, all in a web browser. Cf. Hamilton (8th), p. 559, n. 10. The meeting can be in a particular physical location, with shareholders having the choice of attending physically or logging in; alternatively, the statute authorizes the meeting to take place "***solely*** by means of

remote communication," in which case there would be no physical location at all. §211(a)(2)(B).

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(FORMALITIES FOR SHAREHOLDER ACTION)*

26. Ferdinand de Gama is the chairman of the board of the Cheap & Good Boat Company. Cheap & Good's articles of incorporation have a purposes clause, limiting the company's boat production to pleasure boats no longer than twenty feet. De Gama believes that there is much money to be made in larger, ocean-going vessels. He gets the board to call for a special meeting of the shareholders, to discuss amending the purposes clause in the articles to encompass larger vessels. That's the agenda that's included in the notice to shareholders announcing the special meeting. The corporate president, Marco Polo, convenes the meeting. After the shareholders vote in favor of the amendment, de Gama figures that, since everyone's all together anyway, it would be an ideal place to discuss a merger with the Chinese Junk Company, which specializes in ocean-going vessels. The combined company would be known as the Cheap Junk Company. Discussion takes place, and the shareholders then present approve the merger. Has the merger received proper shareholder approval? ___________________________

27. Popeye tires of life at sea and decides to open a chain of massage parlors, "Sweet Pea Parlors, Inc." There are 100 shares outstanding. Popeye owns 51 shares, Olive Oyl 30 and Bluto 19. Each shareholder is elected to the 3-person board of directors. At a time when each of the three stockholder/board-members has 2 1/2 years to go on his board term, Popeye sells his shares to Sea Hag. (Assume that there are no share-transfer restrictions preventing this.) The corporation's charter is silent on the issue of cumulative voting. Sea Hag wants to join the board of directors immediately (and in fact would prefer to replace all directors with ones beholden to her.) Because of bad lawyering by Sea Hag's lawyer, the share-purchase agreement did not require Popeye to resign from the board, and he refuses to do so now. The state has enacted the MBCA. What procedural step would you advise Sea Hag to take right away (and how will things work out if she takes that step)?

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28. Same basic facts as the prior question. Now, assume that, at a duly-noticed shareholders meeting, Olive Oil and Bluto show up, but Sea Hag doesn't. (Nor does Sea Hag give anyone else her proxy). At the meeting, Olive Oil introduces a motion to change the company's accountant. (Assume that this is a proper subject for shareholder action. Also, assume that the charter and bylaws are silent about all issues relevant to this question.)

(a) Assume that both Olive Oil and Bluto vote their shares in favor of the motion. Is the corporation now authorized to change accountants?

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(b) Assume that Olive Oil votes her shares for the motion, and Bluto votes his shares against it. Putting aside any issue of procedural irregularity with respect to the holding of the meeting, has the motion passed? ______________________________

Answers

26. **No, because the merger was not mentioned as one of the purposes of the meeting.** Shareholders are entitled to notice of both annual and special shareholders' meetings. If the meeting is "special" (i.e., a meeting other than the annual meeting), as is the case here, virtually all states say that the notice must include a statement of the meeting's purpose. [80] See, e.g., MBCA §7.05(c) ("Notice of a special meeting must include a description of the purpose or purposes for which the meeting is called.") What this statement does is limit the scope of what may be discussed at the meeting, since no unstated business can be transacted at the meeting. Since the notice didn't mention the merger, it can't be discussed.

(No statement of purposes is required in the notice for the *annual* meeting, by contrast. But even as to an annual meeting, if a merger will be discussed, shareholders must be told in advance that this will happen, and must be given the details of the plan. See, e.g., MBCA §11.04(d). So even if de Gama was making his merger proposal at the annual meeting as opposed to at the special meeting, the merger couldn't be approved without this proposal's having been mentioned in the notice-of-meeting.)

27. **You should advise her to call an immediate special meeting of shareholders, at which Sea Hag will move to remove all directors without cause.** Most states now allow the holders of a certain percentage of shares to call a special shareholders' meeting at any time. The MBCA allows any holder or holders of more than 10% to do this (see §7.02(a)(2)). Then, the shareholders can, under the MBCA (as under the law of most states today), remove any director by majority vote, even without cause. So, because the corporation doesn't have cumulative voting, at the meeting Sea Hag can cast all her votes (51% of the total votes cast) to remove all three directors. She can then elect herself to one of the vacancies by majority vote. Then, she can (either as the sole member of the board or as majority shareholder) elect two new directors to fill the vacancies. Thus she gets complete board control without waiting for the prior directors' terms to expire. (If the corporation had had cumulative voting, Sea Hag would only have been able to remove two directors and control the election of their replacements — by the formula on p. 56, she would have had just exactly the 51 shares (153 votes) needed to elect two of three directors, and not enough to elect all three.)

28. **(a) No, because there was no quorum for the meeting.** Unless the charter or bylaws provide otherwise (which the facts say they don't), a shareholder meeting requires a quorum of at least a bare majority of the outstanding shares entitled to vote on the measures at issue. Since only 49 of 100 shares were present, shareholder action could not validly take place.

(b). Yes, since we're told to ignore the quorum problem. The real issue in this sub-question is whether the fact that less than a majority (i.e., only 49%) of the total shares outstanding voted for the measure prevents the measure from passing. The answer is "no" — all that's required is that a majority of those shares *actually voting* vote for the measure. (States differ in how they treat abstentions, but that's not an issue here.) Since 30 out of the 49 votes actually cast voted for the measure, it passed.

Exam Tips *on*
THE CORPORATE STRUCTURE

Here are the main things to watch for in connection with the corporate structure:

- ☛ Whenever your fact pattern describes an attempt to ***remove a director***, here's what you should keep in mind:
  - ☞ The ***shareholders***, by majority vote, can always remove a director for ***cause*** (e.g., fraud, gross incompetence, or a breach of the duty of loyalty).
  - ☞ Also, most modern statutes (including the MBCA) let a ***majority of the shareholders*** remove a director ***even without cause***, unless the corp's charter provides differently.
  - ☞ ***Directors***, even by majority vote, ***cannot*** remove a fellow director even for cause, unless the charter or bylaws specifically say they can.
  - ☞ The ***court*** may (under most modern statutes) remove a director for ***cause*** (e.g., fraudulent or dishonest conduct, or gross abuse of power).
- ☛ If your fact pattern involves the ***removal of an officer*** (e.g., the president), here's what you should remember:
  - ☞ The ***board*** has the power to remove an officer, ***with or without cause***. That's true even if the officer has an employment contract — the board has power to remove the officer anyway (and the officer's only recourse is a suit for damages, not a suit to enjoin the dismissal or to compel reinstatement).
  - ☞ ***Shareholders***, even by majority vote, do ***not*** have the power to remove an officer.
- ☛ ***Election of directors*** is often tested.
  - ☞ The most common issue about election of directors involves ***filling board vacancies***. Here, the usual rule (and the MBCA approach) is that the vacancy can be filled ***either by shareholder vote*** or ***board vote***.
  - ☞ Don't overlook the possibility that a corp. may have ***cumulative voting***. In cumulative voting, a shareholder may ***aggregate his votes*** in

favor of fewer candidates than there are slots available.

> *Example:* A, B and C each own 100 of G Corp's 300 shares outstanding, and are its 3 directors under annual terms. C dies, and D inherits her shares. The bylaws say that a 90% majority is required for election of new directors. You have to say whether, at the next holders' meeting, D can elect herself as a director, against the wishes of A and B. If G Corp. has cumulative voting, D can do so — she can cast all 300 of her votes in favor of herself, and thus come up with a "100% vote" (i.e., 1 vote for each share outstanding) for herself, even if A and B don't vote for her.

☛ You'll sometimes be asked about when shareholders can ***compel the calling of a special shareholders' meeting***. In general, the board is ***not obligated*** to call such a meeting (even if a majority of holders requests it) unless the particular action sought to be accomplished must be approved by shareholders.

Example: P, majority holder of X Corp., wants to remove Pres., the corp's president. P calls for a special meeting of shareholders to consider his motion to fire Pres. The board refuses. P can't compel the board to hold the special meeting, because shareholders don't have the power to fire officers, and therefore don't have the right to call a special meeting to consider the firing of officers.

☛ Issues involving the ***corporate structure*** are often hidden in fact patterns that tell you about the provisions of the corp's ***charter*** and ***bylaws***. ***Be certain to read these charter and bylaws terms carefully***, because they're likely to be implicated in events that you're told about later in the question.

☞ If the facts indicate that the board has taken an action which ***conflicts*** with the corp's ***charter***, remember that the charter can ***only be altered by the shareholders***, not the board — so the board's action is probably illegal.

> *Example:* X Corp's charter says that the board consists of 5 members, who will be elected annually. The board unilaterally votes to expand its size to 9, and to stagger terms. This action will be illegal, because only a majority of shareholders, not a board majority, may vary the

charter.

- ☛ Whenever you have to decide the validity of a particular board action, check for failure to comply with ***notice***, ***quorum*** and ***meeting*** requirements. In particular:
  - ☞ A special meeting of the board must normally be preceded by ***notice*** to the board members. The notice must specify the subject(s) (and no unlisted subject may be discussed).
    - ☞ However, the notice requirement will be deemed ***waived*** as to any director who ***attends the meeting*** and does not object at the start of the meeting to the lack of notice.
  - ☞ The board may act only if a ***quorum*** is present.
    - ☞ If the board has a ***fixed size***, a quorum is a majority of ***that size*** (even if there are now vacancies).
    - ☞ If the board has a ***variable size***, a quorum is a majority of the directors ***in office*** at the start of the meeting.
    - ☞ Most states let a corporation's charter or bylaws establish a ***supermajority*** requirement for a quorum. (*Example:* Corp's bylaws say that a quorum will consist of 5 out of its 7 directors. This provision will be given effect, so a meeting at which only 4 of 7 are present will be of no effect.)
  - ☞ Normally, the board may take action ***only at a meeting***. Directors must be ***present to vote*** (i.e., they ***may not vote by proxy***). (*Example:* Paul, one of Corp's directors, can't come to the board meeting, so he gives his proxy to Steve, and has Steve vote for him at the meeting. Paul won't be deemed present, and his vote won't count.)
    - ☞ Look out for the possibility of a ***telephone meeting***: in most states (and under the MBCA), if the director is present for a conference call in which a quorum participates, the director is deemed to be in attendance at the meeting, and his vote counts.
    - ☞ The board may take action only upon a vote of a ***majority*** of the directors ***present at the meeting***. (So the action doesn't have to be supported by a majority of directors in *office*, only a majority of those *present*, assuming that a quorum is present.)

    - ☞ If the facts indicate that the meeting/quorum/majority-vote requirements ***weren't met***, consider the possibility that the board action is valid anyway, because the directors subsequently ***ratified*** it by affirming it or failing to disavow it.

      Example: No quorum is present when the board purports to approve a contract with a third party. A year later, at a regular meeting, attended by a quorum, a majority of those present vote to approve the transaction. This is a ratification, so the contract is binding as if it had been properly approved the first time. (Same result if the board ***tacitly*** ratifies, as by ***accepting benefits*** under the contract.)

- ☛ Whenever the fact pattern states that an officer acted on behalf of the corp., consider whether the officer had ***authority*** to bind the corp. under any of these 4 doctrines: (1) ***express actual authority***; (2) ***implied actual authority***; (3) ***apparent authority***; and (4) ***ratification***.

  - ☞ Look for indications as to whether the officer was ***expressly*** authorized to make the contract. An explicit grant of authority usually comes from either the corp's bylaws, or from a resolution adopted by the board. (Usually this form of authority is so easy that you won't find it in your facts.)

  - ☞ If the officer had a ***title*** within the corp. that would typically include the power to make the deal in question, then the officer had ***"implied actual authority"*** (i.e., authority that's "inherent in the office.") (*Example:* Pete, who is actually the Pres. of Corp., signs a deal to buy office furniture "Corp, by Pete, its President." Pete has implied actual authority, because the president of a corporation would typically have authority to make a deal for furniture.)

  - ☞ Look for situations in which ***extraordinary*** action is taken by the corp.'s president, without board approval. Such action is probably ***invalid***, since it doesn't fall within any form of authority.

    Example: X Corp. is a 10-employee business with $1 million in annual revenues. Pres., the president of X Corp., signs an agreement to pay a $100,000-per-year lifetime pension to a retiring vice-president. The board isn't told of the agreement, and thus doesn't authorize it. The contract is probably not enforceable against X Corp., because it was an extraordinary contract, that did not fall within any theory of authority. (For instance, the authority isn't "implied actual," because such a deal is too large and unusual to come within the usual powers of the president of a corp. this size.)

CHAPTER 6

THE DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

ChapterScope

This Chapter discusses a director's and officer's fiduciary duty to exercise due care when making decisions. Key concepts:

- **Duty of due care:** A director or officer must behave with the level of care that a ***reasonable person*** in similar circumstances would use.
  - ❑ **Personal liability:** If the director or officer is found to have breached this duty of care, in a way that causes loss to the corporation, he may be held liable for ***money damages***, which are to be paid to the corporation.
- **Business judgment rule:** The court will not find an absence of due care merely because the officer/director's decision turns out to have been an unwise one. The "business judgment rule" says that there's ***no breach*** of the duty of care where 3 requirements are met:
  - ❑ the director or officer had ***no conflicting self-interest*** in the matter that he decided;
  - ❑ he made himself ***adequately informed*** about the facts relevant to the decision; and
  - ❑ his decision was ***"rational"*** as of the moment it was made.

I. INTRODUCTION

A. The duty of care generally: This chapter considers the duty of directors and officers to ***act carefully*** when they act on behalf of the corporation.

B. Broad statement of duty: Stated in its broadest form, a director's or officer's duty of care is as follows: He must, in handling the corporation's affairs, behave with the level of care that a ***reasonable person*** in ***similar circumstances*** would use. This sounds like the familiar negligence standard from tort law, and in many ways it is.

1. **Protection of "business judgment" rule:** However, a key rule called the ***"business judgment"*** rule in fact makes the duty of care much less burdensome than you might guess. Stated most briefly and generally, the business judgment rule says that courts will ***not second-guess*** the wisdom of directors' and officers' business judgments, and will not impose liability for even stupid business decisions so long as the director or officer (1) had ***no conflict of interest*** when he made the decision, (2) gathered a reasonable amount of ***information*** before deciding, and (3) did not act ***wholly irrationally***.

2. **Effect of combining the two rules:** When the duty of due care is combined with the business judgment rule, what we really have is a scheme that looks quite closely at the ***process*** by which the director or officer makes his decision, but then gives very little scrutiny to the substantive wisdom of the ***decision itself***. Thus a director who does not attend board meetings, or who acts without a serious attempt to obtain the available facts, is likely to be found to have violated his duty of care. By contrast, a director who tries hard, gets most of the available facts, and then makes a decision which is clearly unwise (even when viewed *without* the benefit of hindsight) probably will ***not*** be found to have violated his duty of care — the business judgment rule will protect him as long as his decision was not totally irrational.

C. **Liability for damages vs. injunction:** If a director or officer violates his duty of care to the corporation, and this violation causes loss to the corporation, the director/officer will be ***personally liable*** to pay ***money damages*** to the corporation. Often, this will come about procedurally by means of a shareholder's derivative suit (see *infra*, p. 318), in which a shareholder sues "on behalf of" the corporation against the negligent director or officer; if the plaintiff is successful, the director/officer will have to pay damages to the corporation, and the shareholder/ plaintiff will share *pro rata* with all other shareholders by virtue of the corporation's recoupment of its losses.

1. **Injunction:** However, there is a quite different context in which the duty of care and the business judgment rule may also be relevant. This is the situation in which the board of directors has approved (but not yet consummated) a transaction, and a shareholder or outsider sues for an ***injunction*** to block the proposed transaction. If the court concludes that the directors or officers have not acted with due care, and that shareholders as a whole would be injured, it may block the proposed transaction until it is approved with the required level of diligence.

   a. **Easier decision:** In general, courts are probably willing to block a proposed transaction (especially in the takeover area) on less of a showing of a violation of due care than they would require before imposing personal liability on directors and officers. This is easy to understand: blocking a transaction that is unfair to shareholders probably will not directly (and certainly not unfairly) hurt the directors and officers who approved it, whereas making them personally liable for potentially huge damages as the result of their service to the corporation may severely hurt them, even bankrupt them.

D. **Only rarely happens:** In general, it is ***very rare*** for directors and officers to be found liable for breach of the duty of due care, as distinguished from breach of the duty of loyalty (discussed *infra*, p. 197). At least traditionally, most of the cases purporting to impose liability for lack of due care have probably really been cases in which the court believed that the directors were engaged in ***self-dealing*** (i.e., they violated their duty of loyalty), but because the proof of self-dealing was not strong enough, the court based its decision upon lack of due care.

1. **Modern trend:** However, beginning in the 1980s a few cases have found lack of due care even without indications of self-dealing. Therefore, the duty of care is becoming a duty that has some real practical impact upon how corporations are managed.

See especially the dramatic and instantly-landmark case of *Smith v. Van Gorkom, infra*, p. 186, in which the Delaware Supreme Court found the directors of a corporation liable for damages because they did not obtain the highest possible price from a takeover bidder, even though the sale price was substantially higher than the stock had ever previously traded, and even though there was no apparent taint of self-dealing.

E. Directors vs. officers: The duty of care is imposed on both ***officers*** and ***directors***. Essentially the same duty is imposed upon each. However, the duty that is imposed is the duty to behave reasonably "under the circumstances," and the circumstances are obviously somewhat different for an officer than for a director. For instance, an officer will typically have deeper knowledge about the company's affairs than will an outside director, so facts which might not give an outside director cause to investigate might give the officer such cause, making his failure to investigate a violation of due care even though the director's failure would not be. In general, everything we say below applies to ***both directors and officers*** unless otherwise noted.

II. THE STANDARD OF CARE

A. The basic standard: Virtually all states impose, either by statute or case law, a duty of ***due care*** on all officers and directors. The director or officer "must exercise that degree of skill, diligence and care that a ***reasonably prudent person*** would exercise in ***similar circumstances***." Clark, p. 123.

1. MBCA: The MBCA spells out this duty in a way that is typical of the law of most states: "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith; and (2) in a manner the director ***reasonably believes*** to be in the ***best interests of the corporation***." §8.30(a).

2. No "accommodation" or "dummy" directors: An important consequence of this duty of care is that there is ***no such thing*** as an ***"accommodation"*** or ***"dummy"*** director.

Example: Suppose that X, who knows nothing about business, as a favor to his friend the President of ABC Corporation, accepts a director's post on ABC's board. President assures X that X will only be a "figurehead" who is not expected to have any significant function in ABC's affairs. Despite these assurances, a court will hold that X had a duty of care to ABC (and indirectly to its shareholders and creditors), and that he can be liable for damages if he does not act in accordance with this duty. "[A] person who accepts a directorship without assuming the responsibilities of a director is courting disaster." Nutshell, p. 310.

3. **Personal liability:** A director or officer who violates his duty of due care, and who thereby injures the corporation, may be held ***personally liable*** for the corporation's damages. This is true even if the director is paid little or nothing for his director's services, and otherwise had little or nothing to gain. In the case of a major corporation, the potential liability can be many times the director's net worth! (For this reason, most corporations now pay for directors' and officers' liability insurance. However, the existence of deductibles, co-insurance provisions and other limits means that even with insurance, a director is probably still significantly at risk if he violates his duty of due care.)

4. **Egregious cases:** However, this duty of due care is not as draconian as it might sound. First, under the "business judgment rule" (*supra*, p. 169), the actual business decisions made by a director or officer will not be second-guessed by the court as long as they are rational, made in good faith, and based on reasonable information. Therefore, liability for breach of the duty of due care generally arises only where the director or officer has failed to comply with reasonable ***procedures*** for making decisions. Second, even where the director's procedures are inadequate, most courts hold that there is only liability for ***"gross negligence***" or ***"recklessness."***

   a. **Total failure to act as director:** Therefore, most successful claims against directors have come in cases where the director simply ***fails to do the basic things that directors generally do***.

Thus a director might be found grossly negligent (and therefore liable) if he does some or all of the following:

[1] fails to ***attend meetings***;

[2] fails to ***learn anything*** of substance about the company's ***business***;

[3] fails to ***read reports***, financial statements, etc. given to him by the corporation;

[4] fails to ***obtain help*** (e.g., advice of counsel) when he sees or ought to see signals that things are going seriously wrong with the business; or

[5] otherwise "neglect[s] to go through the standard motions of ***diligent behavior***." Clark, p. 125.

Example: Mrs. Pritchard is a director of Pritchard & Baird, a reinsurance broker. Pritchard & Baird goes bankrupt, and its trustees in bankruptcy sue Mrs. Pritchard for violating her duty of due care as a director. They show that two officers of Pritchard & Baird, Charles and William Pritchard (who are the other two directors, are Mrs. Pritchard's sons, and are the sole other stockholders apart from Mrs. Pritchard) have misappropriated $12 million from trust accounts held by the company on behalf of others. During the years the misappropriation took place, Mrs. Pritchard was elderly, alcoholic, and depressed over the death of her husband. She hardly ever attended board meetings (which were in fact rarely held), knew nothing of the corporation's affairs, never read or obtained any financial statements, and in general "did not pay any attention to her duties as a director or to the affairs of the corporation."

Held, Mrs. Pritchard (and after her death, her estate) ***breached her duty of due care to the corporation***, and is therefore liable for the losses caused by the misappropriations. Directors are not required to conduct a detailed inspection of day-to-day activities. But they must at least become familiar with the fundamentals of the business, and must keep informed in a general way about the corporation's activities. Here, had Mrs. Pritchard done even so little as to read the corporation's financial statements at any time, she would have noticed an item called "loans to shareholders" which dwarfed the company's assets, and which would have immediately put her on notice that her sons were effectively stealing trust funds. Had she noticed this, and asked her sons to stop, they probably would have done so (so that her negligence was a but-for cause of the losses). ***Francis v. United Jersey Bank***, 432 A.2d 814 (N.J. 1981).

b. Disguised "self-dealing" cases: Cases in which directors are held liable for failing to act with due care are often ***disguised "self-dealing" cases.*** That is, the court believes that the directors acted in pursuit of their own ends rather than for the good of the corporation, yet there is not enough evidence of this to make it the basis for the finding of liability; therefore, the court seizes upon lack of due care instead. Clark, pp. 126-28. For instance, in *Francis*, *supra*, the court was probably swayed by the fact that D was the mother of the two miscreants, and her refusal to undertake any of the responsibilities of a director may have been motivated in part by her desire to let her sons enrich themselves at the corporation's expense. See Clark, p. 127-28.

B. Subjective vs. objective standard: The standard of care is basically an ***objective*** one. That is, the director will be held to the standard of care that would be exercised by a ***"reasonable person"*** in the director's position. Consequently, a director who is simply less smart, less able or less innately diligent than an "ordinary" reasonable director will nonetheless have to meet this higher ordinary standard.

Example: Consider Mrs. Pritchard in the *Francis* case, *supra*, p. 172. Even though she was elderly, alcoholic and depressed over the death of her husband, these factors were not taken into account by the court in determining what level of care was "reasonable" for her. Instead, she was required to conform to the level of directorial skill and diligence that an ordinary "reasonable" director would have shown under the circumstances.

1. **Special skills of director:** On the other hand, if the director has ***special skills*** that go beyond what an ordinary director would have, he ***must use*** those skills. For instance, if the director is by training an accountant, and he learns of facts which would make a trained accountant suspicious but would not raise the suspicions of an ordinary non-accountant director, he must behave as a reasonable accountant would behave under the circumstances. The rule would be similar for one with special ***legal***, ***banking*** or ***real estate*** training. Nutshell, p. 310.

C. **Surrounding circumstances:** The level of care required is that which is reasonable ***in the circumstances*** in which the director finds himself.

1. **Nature and size of business:** These "circumstances" include the ***nature*** and ***size*** of the particular business. For example, if the corporation is small and its operations relatively simple, the level of attention required of the director is probably somewhat less than if he sits on the board of, say, General Motors. Also, if the business serves as trustee or custodian for the ***funds of others***, probably a "reasonable" degree of care under the circumstances would include being on the lookout for misappropriation. Thus directors of banks are sometimes said to owe a "higher" standard of care; however, it would be more accurate to say that they owe the same "reasonable" duty of care as any other director, but that in a banking context this duty includes the obligation to be watchful for signs that depositors' accounts are being looted.

D. **Reliance on experts and committees:** Only rarely can a director, especially a director of a large corporation, directly ascertain the condition of the business. A director of IBM probably has no reasonable way to determine that the company's big supercomputer development program is way behind schedule, that its Singapore branch manager is fixing prices with his counterpart from Hitachi, or that the person overseeing the company pension plan is embezzling. Directors normally rely heavily on the ***expertise*** and

assurances of others, including the company's officers, lawyers, accountants and other persons who are in a better position to know the facts. Generally speaking, the director is ***entitled to rely*** on these other people, and is not expected to go behind what they tell him.

1. **Model Act:** Thus MBCA §8.30(b) provides that
   "(f) A director is ***entitled to rely*** … on:

   (1) one or more ***officers or employees*** of the corporation whom the director ***reasonably believes to be reliable and competent*** in the ***functions performed*** or the information, opinions, reports or statements provided;

   (2) ***legal counsel, public accountants***, or other persons ***retained*** by the corporation as to matters involving ***skills or expertise*** the director ***reasonably believes*** are matters (i) within the particular person's ***professional or expert competence*** or (ii) as to which the particular person ***merits confidence***; or

   (3) a ***committee*** of the board of directors of which the director is not a member if the director ***reasonably believes the committee merits confidence***."

2. **Reliance unreasonable:** On the other hand, it's vital to remember that the reliance must be ***reasonable***. Thus if the director knows facts which indicate that the officer, lawyer, or other third person is ***lying*** or is ***otherwise mistaken***, the director cannot bury his head in the sand and continue to rely on this third party's statements. As the MBCA puts it, the director may rely on the third party's statements, opinions, etc. (including financial statements) only so long as the director "does not have knowledge that makes reliance unwarranted[.]" §8.30(e).

   Example: X is the director of Corporation, a large construction contractor. There have been persistent rumors that high-level officials of Corporation have bribed foreign officials to get foreign construction contracts, in violation of the federal Foreign Corrupt Practices Act. The board appoints a special board committee to investigate; the committee comes back and reports that there is no substance to these allegations. Ordinarily, X would be permitted to rely on the committee's report, since he "reasonably believes the committee merits confidence" (see MBCA §8.30(b)(3)). But if X has actually been told by Y that Y and others have paid $10 million of Corporation's funds to Z to induce Z to give Corporation a contract, X's reliance on the committee is no longer reasonable, because of this actual knowledge. Therefore, X may not hide his head in the sand and say, in effect, "Everything's okay because the committee says so." He must instead explain what he knows, and at least attempt to prevent recurrences.

a. **Tough standard for P to meet:** But it tends to be difficult for a plaintiff who is suing the directors to establish that the board's reliance on employees, experts, etc. was so unreasonable as to violate the duty of care. As we'll see in a little while (*infra,* p. 182), under the ***"business judgment rule,"*** if the board has no conflicts, is adequately informed, and merely makes a "rational" decision, that decision will not be deemed to violate the duty of care merely because it seems somewhat unwise or unreasonable after the fact. Therefore, the board's decision to rely on, say, an expert's recommendation will be protected under the business judgment rule ***so long as the board's procedures are reasonable***, even if the board does not make a very deep analysis of that recommendation before approving it.

Example: The Board of Walt Disney Co. ("Disney") approves an employment contract for Michael Ovitz, under which Ovitz is appointed president (number two) at Disney. The contract includes severance provisions under which if Ovitz is terminated without cause before the contract has run for seven years, Ovitz will receive a lucrative severance package. Ovitz in fact leaves by mutual agreement after 14 months, and ends up collecting the huge sum of $140 million in severance. In a derivative action, Disney shareholders sue the board, alleging that the board failed to use proper procedures in approving the contract, especially by failing to calculate how much severance Ovitz would receive in the event of an early no-fault termination. The complaint alleges that had the directors done such a calculation, they would have realized that the contract gave Ovitz a large incentive to exit the company by a no-fault termination as soon as possible.

The complaint also says that the board was negligent in relying on the advice of its compensation expert, Graef Crystal, who himself did not seem to have calculated how much severance Ovitz would be entitled to if he left early. The Ds (the directors) move to dismiss for failure to state a claim.

Held, for the Ds. Even if the board did, as alleged, fail to calculate the potential cost to Disney of an early no-fault exit by Ovitz, the allegation fails to create a reasonable doubt that this constituted lack of due care. "It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second-guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment.'" Here, the board's reliance on Crystal, despite Crystal's failure to fully calculate the amount of potential severance, lacks egregiousness. "[T]he duty of care is still filled even if a Board does not know the exact amount of a severance payout but nonetheless is fully informed about the manner in which such a payout would be calculated. A board is not required to be informed of every fact, but rather is required to be reasonably informed." ***Brehm v. Eisner***, 746 A.2d 244 (Del. 2000).

E. Passive negligence: In some situations, the duty of due care arises in connection with a specific, affirmative, action by the board of directors. Thus the board may choose to write a certain loan, approve a certain acquisition, or otherwise make an explicit decision to take (or not take) certain action. In this situation, it's not too hard to determine whether the board members have acted with due care. Many if not most situations, however, involve what might be called ***"passive"*** negligence, or "nonfeasance." That is, circumstances exist which the board (arguably) ought to notice and do something about, but instead the board members do nothing. Most commonly, this kind of situation arises when the board fails to ***detect wrongdoing*** by officers or employees of the corporation.

1. No duty to detect wrongdoing: The directors certainly do not have any explicit duty to ***in fact detect wrongdoing***. That is, most courts would probably hold that the board members need not be suspicious sorts who go out of their way searching for evidence of embezzlement, bribery, self-dealing or other misconduct by operating-level managers or employees. As the Delaware Supreme Court has put it, "[A]bsent cause for suspicion there is no duty upon the directors to install and operate a ***corporate system of espionage*** to ***ferret out wrongdoing*** which they have no reason to suspect exists." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963).

2. **Actual grounds for suspicion:** On the other hand, of course, if the directors are ***on notice*** of ***facts that would make a reasonable person suspicious*** that wrongdoing is taking place, their duty of due care requires that they at least ***investigate further***.

3. **Duty to put controls into place:** Furthermore, many courts today hold that, while the board's duty of care may not require it to install a "system of espionage to ferret out wrongdoing" (*Graham*, *supra*, p. 175), that duty of care *does* require that reasonable ***control systems*** be put in place to ***detect wrongdoing***, even where the board has ***no prior reason to suspect*** that wrongdoing is occurring.

   a. **Limited burden:** But once the board does put in such a control system, the board won't be liable for failure to supervise merely because the control system (and or the persons using it) ***fails to detect wrongdoing.*** The case in the following example demonstrates this.

   Example: Caremark is a medical services firm, which provides various forms of therapy — including treatments for HIV/AIDS and hemophilia — to outpatients. The company participates in various Medicare and Medicaid programs. A federal law, the Anti-Referral Payments Law (ARPL), forbids firms such as Caremark from paying doctors to refer Medicaid and Medicare patients to it. Caremark pays physicians fees for monitoring certain patients, including Medicare and Medicaid patients, that are under the firm's care. Federal prosecutors indict the company on various felonies arising out of these monitoring fees, on the theory that the fees violate ARPL. The company settles these charges by pleading guilty to a single felony count, and then spends $250 million to settle various related civil claims against it. No senior officers or directors of the firm are charged with wrongdoing. Stockholders then bring a derivative suit on behalf of the company against all members of the Board of Directors, claiming that the board members failed to exercise their duty of due care, which (the suit asserts) required them to put in control mechanisms that would have prevented the violations of ARPL. The parties then propose to settle the suit, without the Ds paying any money, but with the company taking various steps to avoid future violations of law. The court is asked to approve the settlement.

Held, the settlement is approved. In deciding whether a settlement involving no financial recovery is reasonable, the court must of course take into account the likelihood that the plaintiffs would have prevailed at trial. Notwithstanding *Graham*'s statement about “espionage,” “A director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and … failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.”

However, the burden on a plaintiff who wants to establish a breach of this obligation is a high one: “only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability.” Here, there is no evidence that the director Ds were guilty of such a sustained failure of oversight. The mere fact that the corporation committed a criminal violation does not by itself establish such a failure of oversight by the board. Since the Ps would be unlikely to prevail on the merits at trial, the settlement is reasonable despite its failure to call for any financial recovery. ***In Re Caremark Int'l. Inc. Derivative Litigation***, 698 A.2d 959 (Del. Ch. 1996).

b. Approved by Delaware Supreme Court (*Stone v. Ritter*): *Caremark, supra,* was a decision by the Delaware Court of Chancery, not the Delaware Supreme Court. But in a later decision, the Delaware Supreme Court affirmed the basic test articulated in *Caremark* for when directors could be liable for an omission. In ***Stone v. Ritter***, 911 A.2d 362 (Del. 2006), the court cited *Caremark* approvingly, and said that, assuming the corporation has an exculpation clause (see *infra*, p. 178), the ***directors will have liability for poor oversight only if:***

"(a) the directors utterly ***failed to implement any reporting or information system*** or controls; or

"(b) having implemented such a system or controls, ***consciously failed to monitor or oversee its operations[,]*** thus disabling themselves from being informed of risks or problems requiring their attention."

i. Knowledge of shortcoming required: The *Stone* court then continued: "In either case [i.e., failed-to-implement-a-system or failure-to-monitor/oversee-the-system], imposition of liability requires a showing that the directors ***knew that they were not discharging their fiduciary obligations***."

ii. Gross negligence not enough: So what might be called ***"oblivious gross negligence" won't be enough*** for director-liability in Delaware, at least where — as is usually the case — the corporation has elected to put into its charter an exculpattion clause ***relieving directors of liability*** for violation of the ***duty of due care*** (see *infra*, p. 178). Unless the directors are ***conscious*** that they were not discharging their fiduciary obligations, ***no amount of inattention will be enough.*** As the Delaware Supreme court said in *Stone*, "a claim that directors are subject to personal liability for employee failures is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'"

iii. Illustration: The facts of *Stone* itself, set forth in the following example, illustrate how hard it is for the plaintiffs to recover — or even get to trial — on a claim in Delaware that the directors should be held personally liable for failing to detect employee wrongdoing. In particular, Delaware courts will be careful not to use the ***benefit of hindsight*** to infer that directors' failure to spot wrongdoing establishes that the directors behaved with the required conscious knowledge that they were not discharging their fiduciary responsibilities.

Example: The plaintiff shareholders in a derivative action (see *infra*, p. 318) allege that the directors of AmSouth, a Delaware-chartered bank, should be held liable for money damages because they failed to detect that the bank's employees were not filing Suspicious Activity Reports (SARs), required by federal anti-money-laundering statutes. (The bank paid $50 million in fines and penalties to resolve the government's SAR claims.) Special procedural rules concerning derivative suits require that in order for the case to go to trial, the plaintiffs must show a substantial likelihood that the directors knew, at the time the derivative suit was begun, that they faced possible personal financial liability from the suit. Since AmSouth has a charter provision exculpating directors for non-bad-faith breaches of the duty of due care (see the discussion of exculpation clauses *infra*, p. 178), the directors face financial liability if and only if they acted in "bad faith." The directors move to dismiss on the grounds that there is no evidence of their bad faith.

Held, for the directors. Where the claim is that the directors failed to make a good-faith effort to supervise the corporation adequately, the plaintiffs must establish bad faith by showing either that the directors utterly failed to implement a reporting or control system, or consciously failed to monitor that system. In either case, liability requires a showing that the directors "knew that they were not discharging their fiduciary obligations." Here, there was unrebutted evidence that the board approved policies requiring the filing of SARs, and delegated to non-board employees the job of monitoring those filings and reporting back to the board about whether the policies were being followed. This is enough to rebut any claim that the directors knew they were not discharging their fiduciary obligations. "In the absence of red flags [which were not present here], good faith in the context of oversight must be measured by the directors' actions 'to assure a reasonable information and reporting system exists' and *not by second-guessing* after the occurrence of employee conduct that results in an unintended adverse outcome." *Stone v. Ritter, supra.*

iv. **Significance:** So in the usual case where a charter provision relieves the directors of money-damage liability for lack of due care, *Stone v. Ritter* establishes that directors of a Delaware corporation will have liability for failure of oversight only if they ***"knew that they were not discharging their fiduciary obligations."*** This is a ***nearly-impossible standard*** for the plaintiffs to meet — unless the plaintiffs can show that the board either (a) "utterly failed to implement *any* reporting or information systems or controls," or (b) "consciously failed" to monitor such a system once it was installed, the directors won't be liable, ***no matter how grossly negligent they were*** in failing to notice that wrongdoing was occurring.

c. **Federal statute on controls:** By the way, a federal statute now expressly requires that public companies institute a system of internal controls. §13(b)(2) of the Securities Exchange Act of 1934 now requires every publicly-held corporation to "devise and maintain a system of ***internal accounting controls***" to guarantee accurate financial statements and to guard against misappropriation of assets.

Most public companies have done this by creating an audit committee that works with the corporation’s accountants to install such controls.

F. **The significance of “good faith,” and director-exculpation provisions in charters:** The question of whether the directors satisfied their duty of due care is often intertwined with the question of whether the directors behaved in ***“good faith.”*** For years, it was unclear whether the duty of good faith was an independent duty, or was instead an aspect of (1) the duty of care, which we’ve been discussing and/or (2) the duty of loyalty, which we will be discussing later (*infra*, p. 197).

1. **Director-exculpation clauses:** Why does it even matter whether the duty of good faith is an independent duty or part of some other duty (due care or loyalty)? At least in Delaware, the most important reason it matters has to do with the right of a corporation to ***reduce or eliminate a director’s liability for money damages*** for certain claims. Del. GCL §102(b)(7) lets a corporation put into its certificate of corporation 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[.]” However, (b)(7) does ***not*** permit the reduction of liability for any breach of the “duty of loyalty” or for any acts or omissions “***not in good faith*** or which involve intentional misconduct or knowing violation of the law.”

a. **Claim of gross negligence as bad faith:** Until 2006, plaintiffs in shareholder derivative actions (*infra*, p. 197) often argued in Delaware that if the board behaved grossly negligently, this gross negligence amounted to bad faith, and thus automatically deprived the board of the protections of a GCL §102(b)(7) clause, which most public corporations have in their charters. (For instance, the plaintiffs in *Stone v. Ritter*, *supra*, p. 177, made such a claim.) But in a series of three decisions by the Delaware Supreme Court, beginning in 2006, the court has held that only a narrowly-defined ***conscious disregard of duty*** — and ***not mere gross negligence*** — can amount to bad faith and deprive the board of the protection of a §102(b)(7) provision. We consider these three decisions in Paragraphs 2 through 4 immediately below.

2. **Claim rejected in *Disney*:** First, in ***In Re The Walt Disney Co. Derivative Litigation***, 906 A.2d 27 (Del. 2006) (also known as the final opinion in *Brehm v. Eisner*), the Delaware Supreme Court said that ***gross negligence without more*** — even including a failure to inform oneself of available material facts — ***cannot constitute "bad faith"*** of the sort that deprives the directors of the protection of a GCL §102(b)(7) exculpatory clause.

   a. **Rationale:** The *Disney* court reasoned that the legislature, in enacting §102(b)(7), desired to afford "***significant protections*** to directors of Delaware corporations." To read the statute in a way that "conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections[.]"

   b. **Consequence:** Therefore, according to *Disney*, to qualify as the sort of bad faith that will deprive a director of the protection of the §102(b)(7) exculpation clause, a director's conduct must rise to the level of an "***intentional dereliction of duty***, a ***conscious disregard*** for one's responsibilities."[1]

3. **Failure of oversight:** Then, in ***Stone v. Ritter***, 911 A.2d 362 (Del. 2006), the court made it clear that this "gross negligence does not constitute bad faith" ruling covers claims that the directors ***failed to adequately supervise*** the corporation's operations. As we noted above (*supra*, p. 177), the directors will have liability for poor oversight only if they either:

   [1] "***utterly failed to implement any reporting or information system*** or controls"; or

   [2] "having implemented such a system or controls, ***consciously failed to monitor or oversee its operations[,]*** thus disabling themselves from being informed of risks or problems requiring their attention."

   Furthermore, the court said in *Stone,* neither of the above two failures will be found to have occurred unless the plaintiff shows that the directors ***“knew that they were not discharging their fiduciary obligations***.”

4. **The “offer to buy the company” scenario:** Then, in the last case of the trio, the Delaware Supreme Court held that this “gross negligence does not constitute bad faith” standard also applies to limit directors’ liability for ***mishandling an offer to acquire the company.*** Only if the directors are shown to have “***utterly failed to attempt to obtain the best sale price”*** will they be liable for bad faith in the takeover context. ***Lyondell Chemical Co. v. Ryan***, 970 A.2d 235 (Del. 2009).

    Example: The directors of Lyondell receive a $48/share buyout offer from Blavatnik at a substantial premium to the existing share price. Blavatnik says that this is his final offer, and must be accepted within one week or it will be off the table. During that week, the directors meet several time to consider the offer, solicit and follow the advice of their financial and legal advisors (which is to take the offer because it’s higher than anyone else will likely pay), at least briefly attempt to negotiate a higher offer, and approve the agreement because they believe it’s simply too good not to pass along to stockholders for their consideration. After the board accepts the offer and shareholders approve it, some investors bring a class action, alleging that the board showed bad faith in not doing more to get a higher price.

    Held, summary judgment granted against the Ps. In the acquisition context, the directors will be liable for breach of the duty of loyalty only if they are shown to have “***utterly failed to attempt*** to obtain the best sale price.” Here, the multiple board meetings, the soliciting and following of the advisors’ advice to take the deal, and the members’ belief that the offer was simply too good not to pass along to stockholders for their consideration, were more than enough to show that the directors did not fail to even attempt to obtain the best price. *Lyondell Chemical Co. v. Ryan, supra* (discussed further *infra*, p. 464).

5. **Summary of "gross negligence" vs "bad faith" in exculpation-clause cases:** Taken together, *Walt Disney*, *Stone v. Ritter* and *Lyondell Chemical* establish several propositions regarding director liability in the common situation in which the corporation has a §102(b)(7) exculpation clause:

   [1] Where there is an exculpation clause, the directors will ***not*** be liable for ***"gross negligence,"*** and will be liable ***only*** if they are shown to have acted in ***"bad faith."***

   [2] "Bad faith" requires a showing that the directors ***"utterly failed to [even] attempt"*** to discharge their fiduciary duties.

   [3] Consequently, where a Delaware corporation has an exculpation clause, it will take a ***very extreme fact pattern*** for the directors to be found liable for breach of the duty of loyalty, assuming the directors were not in a conflict position (see *infra*, p. 197). Essentially, the directors would have to have either (1) ***not even tried*** to discharge their responsibilities, or (2) been fully ***aware*** that the actions they were taking conflicted with their duties.

G. **Failure to make disclosure:** Under some circumstances, directors' or officers' ***failure*** to ***make accurate disclosure of information*** to shareholders may constitute a breach of the duty of due care.

1. **Shareholder action sought:** The most straightforward example arises when directors seek ***shareholder approval*** of some corporate action — when they do so, their duty of due care (as well as their duty of loyalty, see *infra*, p. 197) requires that they ***communicate truthfully*** about the merits of the proposed action.

   Example: Suppose that the board of X Corp. wants to merge the corporation into Y Corp., in a transaction in which X Corp. shareholders will end up with shares in Y Corp. Assuming that state law requires the board of X Corp. to obtain informed shareholder approval of the proposed transaction (as most states would require — see *infra*, pp. 378, 390), the board's duty of due care and loyalty would require it to exercise reasonable care in disclosing to shareholders the facts needed for the holders to make an informed decision. For instance, suppose the board completely failed even to make reasonable efforts to ascertain, or to communicate to X's shareholders, the business prospects for a combined X Corp and Y Corp. A court might well hold that the board's failure to ascertain the facts and disclose them constituted a violation of the duty of due care, making the board liable in, say, a shareholder's derivative action (see *infra*, p. 318).

2. **Shareholder communication not required but given:** Now, however, suppose that the Board of Directors is ***not required*** to communicate with (or get approval of) shareholders on a particular matter, but chooses to do so anyway. If the board communicates incorrect information, can it be liable for a breach of the duty of due care? The Delaware Supreme Court answered "yes," in *Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

   a. **Facts:** In *Malone*, the Ps were shareholders in Mercury Finance Co., and the Ds were directors of Mercury. The complaint alleged that the Ds intentionally and repeatedly overstated the financial condition of Mercury in reports to shareholders and the SEC, in breach of their state-law fiduciary duties. When the true facts were eventually disclosed, the share price collapsed.

   b. **Liability possible:** The court agreed with the Ps that liability was at least theoretically possible if the facts alleged in the complaint were proven. "When the directors disseminate information to stockholders when no stockholder action is sought, the fiduciary duties of care, loyalty and good faith apply. Dissemination of false information could violate one or more of those duties." (Because the complaint was poorly worded — the court couldn't even tell whether the claim purported to be a direct or a derivative one — the case was dismissed with leave to replead.)

   c. **Business judgment rule:** But it's unlikely that a mere error in reporting facts to shareholders would trigger a finding of breach of the duty of due care. The business judgment rule would normally give the board significant protection in the case of an "honest," even if negligent, mistake. However, if the board failed to put into place ***reasonable procedures*** for ***gathering accurate information***, a breach of the duty of care might be found.

H. Causation: Even if a director or officer has violated his duty of due care to the corporation, many cases say that he will not be personally liable unless this lack of due care is the ***legal cause*** of ***damage*** to the corporation. In other words, in many courts the traditional tort notions of ***cause in fact*** and ***proximate cause*** apply in this context.

1. **Cause would have happened anyway:** Thus if the loss ***would have happened anyway*** even had the directors all behaved with due care, many courts hold that there is no liability.

2. **Delaware rejects:** But some states, including ***Delaware***, ***reject*** the requirement of causation when directors are shown to have violated their duty of care. Thus in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) the Delaware Supreme Court held that once P shows that the directors breached their duty of care, that showing overcomes the protection that directors get from the "business judgment" rule (see *infra*, p. 182). At that point, P has established a *prima facie* case — ***even if he can't show that exercise of due care would have avoided the loss —*** and the ***burden of proof shifts to the defendants***: unless the defendants carry the burden of showing the "entire fairness" of the transaction, they will be liable.

3. **Joint and several liability:** When multiple directors are charged with breaching their duty of due care, each will (if she's smart) argue, "Even if I had behaved with due care, the rest of the board would probably not have listened to me, and the loss would have happened anyway." However, at least some courts hold that any board member who violates his duty of due care is ***jointly and severally liable*** with all other directors who have done so, as long as the board ***collectively*** was a proximate cause

of the loss; each director is treated as a “concurrent cause” of the harm, and is liable even though his own due care probably would not have made a difference. See ALI *Prin. Corp. Gov.*, §7.18, Comment d (taking “no position” on whether the liability should be joint-and-several or, instead, apportioned.)

III. THE BUSINESS JUDGMENT RULE

A. The rule generally: The “business judgment rule” may be thought of as a “judicial gloss” on what it means for a director to exercise due care. Even if the director’s conduct might seem to lack due care when viewed from a general “reasonable person” benefit-versus-burden tort perspective, the more precise business judgment rule may save the director from liability.

B. Statement of the rule: There is no single universally-accepted statement of the business judgment rule. The basic idea behind the rule seems to be that “[business] decisions made upon ***reasonable information*** and with ***some rationality*** do not give rise to directorial liability ***even if they turn out badly*** or disastrously from the standpoint of the corporation.…” Nutshell, p. 310. In other words, the court will not find an absence of due care merely from the fact that the decision was ***unwise***.

Example: The Ds are the directors of American Express Co. They have caused the corporation to distribute the shares it holds in a separate company, DLJ, to shareholders as a special dividend. P, an American Express shareholder, brings a derivative suit against the Ds; he alleges that they should have had American Express sell these DLJ shares on the open market instead of distributing them as a dividend. He points out that this technique would have resulted in substantial tax savings to shareholders.

Held, for the Ds. P makes no claim that the Ds engaged in fraud or self-dealing. P is merely claiming that a different decision by the board would have been more advantageous. But a complaint alleging merely that some other decision would have been wiser does not state a cause of action, because of the business judgment rule. ***"More than imprudence or mistaken judgment must be shown."*** Here, the evidence shows that the directors considered the tax advantages of selling the stock rather than distributing it, but were worried that this path would hurt the corporation's reported earnings; their decision will not give rise to liability so long as it was reached in good faith. *Kamin v. American Express Co.*, 383 N.Y.S.2d 807 (N.Y.Sup.Ct. 1976).

1. **ALI definition:** The clearest definition of the business judgment rule is perhaps the one given in the ALI's *Principles of Corporate Governance*:

> **§4.01(c)** "A director or officer who makes a ***business judgment*** in ***good faith*** fulfills the duty [of care] if the director or officer
>
> (1) is ***not interested*** in the subject of the business judgment;
>
> (2) is ***informed*** with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) ***rationally believes*** that the business judgment is in the best interests of the corporation."

a. **Interpretation:** Thus a director who asserts that he is protected by the business judgment rule has to prove three things under the ALI's approach:

[1] that he was not "interested" (i.e., that he had no ***conflict of interest***, no personal stake in the outcome that was different from the corporation's stake);

[2] that he gathered the reasonably needed ***information***; and

[3] that he honestly, ***and rationally***, believed that his decision was in the company's best interest.

So, assuming that the director has no conflicts and gathers adequate information, the essence of the business judgment rule is that ***mere rationality*** is ***all that is required*** — as long as the decision is not entirely crazy or outside the bounds of reason, the fact that (when judged by reference to the facts known to the director) it was ***very unwise***, will not be enough to make the director liable.

2. **Model Act:** The MBCA, by contrast, does not attempt to codify the business judgment rule at all. §8.30(a) sets forth the general duty of due care (including the requirement that the director act in a manner that the director "reasonably believes to be in the best interests of the corporation"). The Official Comment to §8.30 says that the elements of the business judgment rule, and its impact on the duty of due care, are left to the courts.

3. **Relation between general duty of care and the business judgment rule:** At first blush, the business judgment rule seems in conflict with the general duty of due care described above. Probably the best way to see how the pieces fit together is this: The duty of due care imposes a fairly stern set of ***procedural*** requirements for directors' actions — the director must act in good faith (e.g., not be pursuing his own interests), and he must get all reasonably needed ***information*** before deciding. Once these procedural requirements are satisfied, however, the business judgment rule sets out a far more easily satisfied standard with respect to the ***substance*** of the business decision: that decision will be upheld so long as it is "rational" (a weaker requirement than that the decision be "reasonable").

4. **Rationale:** There seem to be three main reasons for limiting directors' liability by use of the business judgment rule:

   a. **Risk-taking directors:** First, a certain amount of ***innovation*** and ***risk-taking*** is essential if businesses are to grow and prosper. It is generally in the shareholders' interests to have their directors take at least rational risks on the corporation's behalf. Without the business judgment rule, directors would become much more conservative and anti-risk, and the overall economic performance of corporations generally would probably decline.

   b. **Courts are poor judges of business reality:** Second, directors — like executives — must constantly engage in a ***"risk/return calculus."*** Judges, especially acting from hindsight, are ***not very good*** at making this kind of calculus — they have no training in it — so they may reach inappropriate conclusions if we let them second guess business people. "A reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge." *Joy v. North*, 692 F.2d 880 (2nd Cir. 1982).

c. **Directors as poor "cost avoiders":** Finally, imposing greater director liability would make directors a form of ***"cost spreaders."*** But any given director is a poor cost spreader, since he probably serves only a few companies, and cannot incorporate the cost of his mistakes into the price he charges for his services. (This is in contrast to the ability of, say, lawyers or accountants to buy malpractice insurance and therefore spread among many clients the cost of law or accounting mistakes.) Shareholders can spread the risk of business misjudgments far more easily by diversifying their portfolios than directors can spread this risk by serving on multiple boards.

See generally *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

C. **Requirements for application of rule:** As we noted above, most courts appear to impose three requirements before the director or officer will gain the protection of the business judgment rule: (1) he must not have any private ***interest*** in the outcome different from the corporation's interests, i.e., there must be no taint of self-dealing; (2) he must have made the judgment only after gathering the reasonably needed ***information***; and (3) he must have ***"rationally believed"*** that his judgment was in the corporation's best interest. See ALI, Prin. Corp. Gov., §4.01(c). We now consider each of these requirements in turn.

1. **No self-dealing:** First, the director or officer will lose the protection of the business judgment rule if he has an ***"interest"*** in the transaction. Thus if he is a ***party*** to the transaction, or is related to a party, or otherwise has some ***financial stake*** in the transaction's outcome that is adverse to the corporation's stake, the business judgment rule will not apply. So any taint of ***self-dealing*** by the director will be enough to deprive him of the business judgment rule's protection.

a. **Rationale:** The rationale behind the business judgment rule is that we want to protect honest (even if mistaken) cases of business misjudgment. But if the director has engaged in self-dealing, he has not really engaged in business judgment (in the sense of judgment on behalf of the corporation) at all — instead he has been engaged in pursuing his own objectives. This conduct is not the kind of action we want to protect with a special rule that makes recovery very difficult. Clark, p. 138.

Example: X is an officer and director of Printing Corp. He votes to have Printing Corp. purchase most of its paper from Paper Corp. Paper Corp. charges an average of 5% more for the same paper as is available, on substantially the same delivery and credit terms, from Discount Corp. Normally, X's decision to vote to have the purchases made from Paper Corp. would be protected by the business judgment rule (assuming that X acts with reasonable information, and his decision is not wholly irrational; see *infra*). However, it turns out that X is a secret substantial shareholder in Paper Corp., who will benefit financially by this large volume of business from Printing Corp. Therefore, X is "interested" in the transaction and he thus will not get the protection of the business judgment rule.

Note: The law governing self-dealing transactions is discussed extensively beginning *infra*, p. 197, and is an extremely important body of law. The point we are stressing here is that self-interested transactions, unlike other transactions, don't get any special benefit from the business judgment rule.

2. **Informed decision:** The requirement that has the greatest practical importance is that the decision must have been an ***"informed"*** one in order to be protected by the business judgment rule. That is, the director or officer must have gathered at least a ***reasonable amount of information*** about the decision before he made it. As one court has put it, the directors must inform themselves "prior to making a business decision, of ***all material information reasonably available to them***." *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

a. Gross negligence standard: However, even with respect to his duty to become "informed," the business judgment rule is not as tough as it might sound. Most courts would probably hold that a director loses the benefit of the rule only if he was ***grossly negligent*** in the amount of information he gathered. In other words, mere "ordinary" negligence in obtaining available information, like mere negligence on the substantive merits of the decision, will not be enough to cause liability.

Example: Suppose that the directors of X Corp. are asked to approve X's acquisition of Y Corp. The President of X gives the directors ten years of financial information on Y, but director D only reads the last three years of this information. D (as well as his fellow directors) approves the acquisition, it goes forward, and it turns out disastrously because of embezzlements carried out by the founder of Y (who is kept on). Had D read the financial statement from seven years previously, he would have discovered in a footnote reason to doubt the honesty of the founder.

On these facts, a court would probably hold that D gets the benefit of the business judgment rule (thus validating his decision to acquire as long as it was not completely irrational) so long as he was not "grossly negligent" in limiting his reading to the three most recent years. Probably a court would find that while this limited research may have been negligent, it was not "grossly" negligent. See, e.g., *Smith v. Van Gorkom* (discussed extensively *infra*, this page), in which the court said "we think the concept of gross negligence is … the proper standard for determining whether a business judgment reached by a board of directors was an informed one."

b. All circumstances considered: In determining whether the decision was an informed one, the court will generally consider ***all of the surrounding circumstances***. For example, if the board's decision had to be made in an extremely ***short time period***, a smaller amount of information will have to be gathered than if the court had months or years in which to make the decision.

c. The key case of *Smith v. Van Gorkom:* The requirement that the decision be an "informed" one is the key to the most important business judgment rule case to be decided in modern times, ***Smith v. Van Gorkom***, 488 A.2d 858 (Del. 1985). *Van Gorkom* represents a striking exception to the usual rule that if there is no taint of self-interest, and at least some attention paid to directorial responsibilities, the business judgment rule will shield the directors for liability for their decision.

i. Facts: The precise facts of *Van Gorkom* are of utmost importance, so we consider them in detail. The Ds were the directors of Trans Union Corp., including its chairman/CEO, Van Gorkom. Trans Union was publicly-held, and Van Gorkom held a sizeable, but minority, stake. Van Gorkom was near retirement age, and apparently wished to sell his shares prior to retirement. He had his chief financial officer compute the price at which a leveraged buyout could be done; the CFO reported that at $50 per share, the corporation's cash flow would easily support a buyout, but that at $60 a share the cash flow might not be sufficient. Van Gorkom then, without consulting with anyone else in senior management, proposed to his friend Pritzker (a well-known corporate acquirer) to sell him the company for $55 per share. The company's price on the New York Stock Exchange had recently fluctuated between $29 and $38, and in its history had never been higher than $39 1/2. Pritzker agreed to a $55 per share buyout price.

ii. Board approval: Van Gorkom did not attempt to get any other offers for the company. Nor did he ever commission a formal study of the company's value. Instead, he went to his board of directors and asked them to approve the sale to Pritzker at $55. He did not invite the company's investment bankers to the board meeting. He told the board that Pritzker was demanding an answer within three days. Most members of senior management opposed the deal on the grounds that the price was too low. The board was not shown the proposed merger agreement, or any documents concerning the value of the company; it relied solely on Van Gorkom's oral presentation, the chief financial officer's statement that the price offered was in the "low" range of appropriate valuation, and an outside lawyer's advice that the board might be sued if they failed to accept the offer. The board approved the buyout on this basis. The sale went through at $55 per share.

iii. Holding: The Delaware Supreme Court, by a three-two vote, held that the directors had been ***grossly negligent*** in failing to inform themselves adequately about the transaction that they were approving. The majority seemed especially influenced by the fact that: (1) it was Van Gorkom, not Pritzker, who promoted the deal and named the eventual sale price, and the board never ascertained this; (2) the board had made no real attempts to learn the "intrinsic value" of the company; (3) the board had no written documentation before it and relied completely on oral statements, mostly by Van Gorkom; and (4) the board made its entire decision in a two hour period, with no advance notice that a buyout would be the subject of the meeting, and in circumstances where there was no real crisis or emergency. (The board claimed that it had reserved the right to take any higher offer, but the court found that this reservation was illusory, because of tight limits that the Pritzker agreement placed upon the board's ability to accept higher offers from third parties. In any event, the two other bidders who came forward never made a serious offer, apparently in part because of limits placed on other offers by the board's deal with Pritzker.)

iv. Dissent: The two dissenters argued that the directors' decision to approve the merger should have been protected by the business judgment rule. One of them pointed out that the directors were highly sophisticated businessmen who were very well informed about the company's affairs.

v. **Significance:** The *Van Gorkom* decision is quite extraordinary. Here we have a buyout done at a price that was 40% above the highest price that the stock had ever traded for in its history. Yet the directors were held grossly negligent for approving the buyout! Perhaps the real key to the decision is that a majority of the court felt that the directors acceded to an autocratic leader (Van Gorkom), rather than making their decision in a collaborative manner. See Clark, p. 129.

vi. **Large stakes:** Observe that the stakes for the defendant directors in a case like *Van Gorkom* are enormous. Had the court finally decided that the buyout was $5 lower than a fully-informed transaction would have been done at, the 20 million shares outstanding would have produced a verdict of $100 million! In reality, the case was settled for $23 million (though this did not come out of the directors' pockets — about half came from directors' liability insurance and the rest from Pritzker, who apparently paid it voluntarily). S,S,B&W, pp. 714-15.

vii. **Lesser guilt:** Also striking is the fact that the other directors were held jointly and severally liable even though Van Gorkom was clearly the person primarily responsible for the transaction. The explanation is probably that the defendants pursued what turned out to be a poor litigation strategy: the court repeatedly asked them whether there were reasons to treat some directors differently from other directors, and they answered "no," preferring to pursue a "one for all and all for one" strategy. See Nutshell, p. 315; S,S,B&W, p. 714. Therefore, the court treated them as being jointly and severally liable.

viii. **Significance:** The *Van Gorkom* case seems most significant for the proposition that ***process*** is exceptionally important in obtaining the benefits of the business judgment rule. Had the board members reviewed the proposed merger agreement, and obtained an investment banker's opinion that $55 was a "fair" price, the court would probably have found that the decision was an "informed" one, and was therefore protected by the business judgment rule. Thus the actual merits of the decision — whether $55 was an appropriate price — wasn't what really made the difference in *Van Gorkom*.

d. Takeover context: As *Van Gorkom* illustrates, directors must do more than merely "go through the motions" in approving major business transactions. Especially in the ***takeover*** area, the directors must go out of their way to gather all relevant information, must take whatever time is reasonably available in the circumstances before deciding, and must interrogate management closely rather than merely "rubber stamping" management's recommendations.

3. The requirement of a "rational" belief: The final requirement for the business judgment rule, according to most courts, is that the director must have ***"rationally believed"*** that his business judgment was in the corporation's best interest. See, e.g., ALI Prin. Corp. Gov., §4.01(c)(3). That is, the director must ***actually*** believe he is acting in the corporation's best interests, and this belief must be ***at least rational***.

a. Meaning of "rational": Observe that the requirement is merely that the belief in the soundness of the decision be "rational," not that it be "reasonable." In other words, so long as the belief is not ***totally beyond the bounds of reason***, it will be sustained even though most people might not have held that belief.

b. Refers to belief, not substance of decision: Also, keep in mind that what has to be rational is the director's *belief* that the decision is in the corporation's best interests, not the *decision* itself. Therefore, as long as the director (1) had a rational basis for believing that he had ***followed sensible decision-making procedures*** (e.g., he rationally believed that he had gathered the appropriate information before deciding), and (2) had a rational basis for believing that he was attempting to pursue the corporation's interests (rather than, say, his own interests), that will be the end of the matter.

i. No scrutiny of merits of decision: An important corollary of this emphasis on the rationality of the "belief," not the rationality of the underlying decision, is that the court ought to focus on the directors' decision-making ***process***, and ***ought rarely to consider the merits of the underlying decision***. As one court has put it, "it is obvious that a court must examine the ***circumstances surrounding the decisions*** in order to determine if the conditions warrant application of the business judgment rule. If they do, the court will ***never proceed to an examination of the merits*** of the challenged decisions, for that is precisely what the business judgment rule prohibits." *Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997). So, for instance, if the case arises in the form of a shareholder's derivative suit (see p. 318, *infra*), and the decision in question is the board's decision to terminate the suit, the court will never consider whether the suit itself had substantive merit, but will merely consider such procedural issues as whether the board or its sub-committee was "independent" when it made the dismissal decision, whether it conducted a reasonable investigation into the merits of the derivative suit, etc.

(1) No 20/20 hindsight: The idea that a court deciding whether to apply the business judgment rule should not review the substantive merits of the underlying decision is often captured by saying that the court ***will not use "20/20 hindsight."*** See, e.g., *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (discussed at length *supra*, p. 175): "It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second-guess a board's decision, except 'in rare cases [where] a transaction may be ***so egregious on its face*** that the board approval cannot meet the test of business judgment.'"

D. Exceptions to rule: Even where these three requirements for the business judgment rule are satisfied, there is at least one kind of situation (and possibly a second) where the court will find the rule

inapplicable.

1. **Illegality:** If the act taken or approved by the director is a ***violation of a criminal statute***, the director will ***lose the benefit*** of the business judgment rule. This is true even if the director was pursuing what he saw as the corporation's rather than his own interests, was acting based on full information, and rationally believed that his action would benefit the corporation (the three standard requirements for the rule). Even if there has been no criminal prosecution, if a civil plaintiff can show that the act was a criminal violation, the defendant will lose the benefit of the business judgment rule and his conduct will be evaluated solely based on the general duty of due care. (The director is then likely to lose, on the grounds that it is not due care to advocate or permit a violation of the criminal laws.)

   a. **Shareholders as protected class:** This "illegality" exception to the business judgment rule is especially likely to be invoked if the court concludes that shareholders are among the ***class meant to be protected*** by the criminal statute in question.

      Example: A statute forbids corporate charitable contributions. The purpose is to protect shareholders' financial interest. If a shareholder sues to recover illegal contributions, the court is likely to hold that the contributions violated the duty of due care if the board knew of them.Cf. *Miller v. American Telephone & Telegraph Co.,* 507 F.2d 759 (3d Cir. 1974).

2. **Pursuit of "social" goals:** Some courts recognize yet another exception to the business judgment rule: the pursuit by a director of broad ***social*** or ***political*** goals not related to the corporation's welfare. For instance, if the directors of a computer corporation (whose operations have very little to do with health care) were to donate, year after year, 50% of its net profits to a foundation for cancer research, a court might well hold that this extreme pursuit of social welfare goals at the expense of the corporation's profitability should not be protected by the business judgment rule. This might be the case even if the directors honestly, though

mistakenly, believed that such donations were in the corporation’s best overall interests (thus perhaps satisfying the “rationally believes” requirement for the business judgment rule).

a. **Contrary view:** However, even in this kind of extreme situation, it is not clear that the court would refuse to apply the business judgment rule. Courts tend to give extremely ***wide latitude*** to directors’ judgments that charitable or social (and perhaps even political) purposes mesh with the corporation’s own financial interests. In any event, the corporation will usually be able to dress up its decision into one that is at least rationally related to the corporation’s own financial interests.

Example: P, a minority stockholder in the Chicago Cubs baseball team, brings a stockholders’ derivative action against the directors of the team. P alleges that one of the Ds, Philip Wrigley (owner of 80% of the stock) has refused to allow lights to be placed in Wrigley Field, not because he thinks this will benefit the corporation but because he holds the personal social/political opinion that “baseball is a daytime sport” and that the installation of lights will have a bad effect upon the surrounding neighborhood.

Held, for Wrigley and the other defendant directors. It is not clear that these motives, even if proven, are contrary to the best interests of the corporation and its stockholders. For instance, if the neighborhood around the park were to deteriorate because of lights, the value of the corporation’s property (the park) would deteriorate; also, patrons might be less willing to come to the park if it were now in a deteriorated, poorer, neighborhood. (The fact that all other teams have implemented night baseball is irrelevant, because “it cannot be said that directors, even those of corporations that are losing money, must follow the lead of the other corporations in the field.”) *Shlen-sky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968).

IV. MODERN STATUTORY MODIFICATIONS TO THE RULES OF DIRECTOR LIABILITY

A. Reason for statutory modifications: As the number of suits successfully holding directors liable for breach of the duty of due care has multiplied, many states have tried to ***counteract*** this trend by modifying their statutes. In general, these states appear to feel that increasing directors' and officers' risk of personal liability does not improve the economic efficiency of business as a whole, and certainly does not improve a state's ability to induce corporations to choose that state as their domicile.

B. Some typical approaches: There are at least four approaches that states have taken to reduce the practical burdens of director liability for money damages for breach of the duty of due care:

1. **Allow shareholders to amend charter:** Some states have allowed the shareholders to ***amend the corporate charter*** to eliminate or reduce directors' personal liability for violations of the duty of due care. For instance, Delaware GCL §102(b)(7) allows the shareholders to modify the corporation's charter to eliminate money damages for breach of the duty of due care, so long as the director has acted in good faith without knowingly violating the law and without obtaining any improper personal benefit. (For more about this provision, see *supra*, p. 178.)

2. **Looser standard of care:** Some states have made the ***standard of care*** looser, so only more egregious conduct will give rise to personal liability. For instance, Indiana and Ohio now allow recovery only where the director has intentionally harmed the corporation or acted "recklessly." See Ind. Code §23-1-35(1)(e)(2); Ohio Code §1701.59.

3. **Limiting damages:** Some states have placed a ***limit*** on the amount of money damages that may be recovered against the director or officer. For instance, in Virginia personal liability is generally limited to $100,000 (or any lesser sum put in the company's charter by shareholder vote). Va. Code §13.1-692.1.

4. **Greater right to indemnify:** Finally, many states now allow

the corporation to completely ***indemnify*** directors and officers for any liability they may have for breach of the duty of due care. This topic is discussed extensively *infra*, p. 341.

See generally S,S,B&W, pp. 734-736.

Quiz Yourself on ***THE DUTY OF CARE & THE BUSINESS JUDGMENT RULE*** *(ENTIRE CHAPTER)*

43. Teddy Roosevelt is chairman of the board of a Delaware-chartered linen supply company, Bully Sheet, Inc. The board of directors is thinking of paying a dividend to the shareholders. (The directors are aware that the jurisdiction, like most, prohibits dividends when the effect would be to leave the corporation unable to pay its bill.) The directors therefore call in the company's chief financial officer, Ben Counter, who tells them that paying the dividend would not affect Bully Sheet's ability to meet its financial obligations. The directors are somewhat surprised by this, since they know that the company hasn't met its payroll recently. Nonetheless, relying on Counter's report, they go ahead and declare a dividend.

(a) A shareholder subsequently brings a derivative action against the directors, trying to hold them liable for improperly paying the dividend at a time when the corporation could not in fact afford to pay it. The directors defend by claiming that they satisfied their duty of care by relying on the opinion of an expert, Counter. Who's correct? ____________________________

(b) What could the board and shareholders of Bully Sheet do to make sure that future claims like the derivative claim in (a) could not possibly succeed? ____________________________

44. Carlo Bonaparte is majority shareholder of the Elba Real Estate Development Corporation. His two sons, Napoleon and Joseph, are minority shareholders, as well as officers and directors of the corporation. When Carlo dies, he leaves his interest in Elba to his widow, Letizia, who also becomes a director. Napoleon, as President, asks for board approval of the use of $1 million of corporate funds to attempt to acquire the island of Sardinia from an unaffiliated third party. In a 3-hour board meeting to consider the acquisition, Letizia and Joseph ask a number of questions, to which Napoleon gives answers that seem at least superficially reasonable. The board also reads a report on the proposed acquisition prepared by the company's accountants; the report concludes that the acquisition will probably be profitable, and that the price, though high, is within a reasonable range. At the conclusion of the meeting, Letizia says, "Well, I'd prefer that we stockpile our cash rather than going into this somewhat risky venture, but Nappy, if you really think it'll work out ok, I'll support you despite my doubts, because you've got a good feel for these real-estate purchase deals and I trust you to make money for the company."

Joseph votes against the acquisition, but between Letizia and Napoleon the proposal has enough votes to pass. A typical reasonably-able real estate investor would probably have voted against the transaction, because the price was about 25% above prevailing prices for such property, and the financial risks were clearly visible. The acquisition proves disastrously unprofitable, and causes the company to go broke. Joseph sues Letizia, alleging that she violated her duty of due care in voting for the acquisition.

(a) If you represent Letizia, what doctrine would you assert as a reason for holding Letizia not liable? ____________________________

(b) If you make the argument referred to in part (a), what will be the likely result of the suit? ____________________________

45. Lillian "Mama" Carlson is chairman of the board of Cincinnati Communications, Inc., (CCI) whose sole asset is radio station WKRP. Lillian rules WKRP with an iron fist, dominating the other seven board members — her son Arthur, Andy Travis, Jennifer Marlowe, Les Nessman, Venus Flytrap, Herb Tarlek, and Dr. Johnny Fever. Sosumi Inc., a giant Japanese communications company, offers to buy CCI for $50 a share. CCI is currently trading on the NYSE at $39 a share. Lillian wants to accept the offer, but realizes she needs board approval. At a special board meeting called on one day's notice, Lillian makes a 20-minute presentation about the offer. She doesn't supply — and the directors don't request — a valuation study or a written copy of the purchase terms. After her presentation, and with very little discussion, she calls for a vote. The directors unanimously approve the sale. They submit it to a shareholder vote shortly thereafter, with their recommendation. The shareholders approve it. Thereafter, a minority shareholder, Bailey Quarters, sues the directors for violating their duty of care to the corporation, asserting that the value was closer to $80 a share. (Assume that Quarters is correct, that another bidder could have been found who would have paid $80.) The directors claim that their decision is shielded by the business judgment rule. What's the likely result?

____

46. Frank N. Stein wants to incorporate in Delaware his business, Frankie's Body Shop, which sells cadavers to be used in medical research. In order to lure qualified directors to his board, he agrees to put a clause in the articles of incorporation attempting to insulate the directors from breaches of the duty of care.

(a) Assume that the clause says, "No director shall be liable for money damages of any sort, arising from the violation of the duty of due care, regardless of the nature of the act or omission giving rise to the violation." Will the clause be enforceable as written?

____

(b) Assume that the clause says, "No director shall be liable for money damages arising from the violation of the duty of due care, so long as the director acted in good faith, without knowingly violating any statute or other law, and without obtaining any improper personal benefit." Will clause be enforceable as written? ______________________________

Answers

43. **(a) The shareholder.** Directors can violate their duty of care through inactivity, as by failing to inform themselves of their corporation's business. They typically can fulfill their duty to keep themselves informed by relying on the advice of experts, such as lawyers and accountants. However, reliance on third parties shields the directors from liability for failure to exercise due care only when the reliance is ***reasonable***. Reliance is not reasonable where the director is on notice of facts or circumstances indicating that the expert is wrong. [174] Here, the directors know that Bully Sheet hasn't met its payroll recently; this flies in the face of Counter's statement that the company could pay a dividend and still meet its financial obligations. Once on notice of facts suggesting that Counter's statement was unreliable, the directors had at least a duty to inquire further, a duty that they did not discharge. Since the payment of the dividend in these circumstances seems to have brought harm to the corporation (by making it further insolvent), the directors are likely to be required to reimburse the corporation for the improperly-paid dividend.

(b) Placing an exculpation clause in the corporation's certificate of incorporation. Del. GCL §102(b)(7) lets a corporation put into its certificate of incorporation "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[.]" The provision can't cover a breach of the duty of loyalty or good faith, but it can cover a breach of the duty of care. Since only the duty of care is involved here, such a provision would make it virtually impossible for a shareholder derivative suit to succeed on these facts.

44. (a) You should assert that the "business judgment rule" bars liability. Under the business judgment rule, a director (or officer) who makes a business judgment in "good faith" fulfills the duty of care if the director (1) has no conflict of interest concerning the transaction; (2) is reasonably well-informed about the transaction; and (3) rationally believes that the business judgment is in the corporation's best interests. [183] You can make a pretty plausible case that Letizia's decision to vote in favor of the acquisition satisfied these requirements (see part (b) below).

(b) Letizia will probably win. As to requirement (1), there's nothing in the facts to indicate that Letizia had any conflict of interest regarding the transaction (for instance, the purchase was made from an unaffiliated third party.) As to requirement (2), the long board meeting, Letizia's detailed questions, and her reliance on the accountant's report, seem enough, taken collectively, to have made her "well-informed" about the acquisition. As to (3), Letizia's belief that Napoleon knew what he was doing seems to have been at least "rational," even if not fully "reasonable." Therefore, Letizia probably qualifies for the protection of the business judgment rule. If the court agrees, it won't hold Letizia liable even though an ordinary director of reasonable prudence would probably not have voted in favor of the transaction, based on the facts then known to the board.

45. **The directors will probably lose.** Directors have a duty of care toward the corporation, which they can violate either through inactivity or negligence. The directors will be protected from even a bad business decision under the business judgment rule, if they meet the three requirements described in the previous answer. The problem is that here, the directors have almost certainly not met requirement (2), that they be reasonably ***well-informed*** before taking the action. The fact that the directors didn't have a valuation study or see a copy of the acquisition agreement, the shortness of the advance notice to directors, the lack of discussion at the meeting — all of these things indicate a lack of reasonable information on the part of the board.

Since the board doesn't qualify for the protection of the business judgment rule, the question becomes whether the board's decision demonstrated "due care" or reasonable prudence. If another buyer really could have been found to pay $80, selling for $50 probably wasn't reasonably prudent. Therefore, the board will probably be held liable to reimburse the corporation for the money that was left on the table. See *Smith v. Van Gorkom*, so holding on roughly the same facts. [186]

Note that, had the directors not been procedurally careless — i.e., had they deliberated and done a valuation, but honestly, mistakenly valued the corporation too low — the business judgment rule probably *would* have protected their decision. (The prior question is an example of how this protection might have applied.)

46. **(a) No, probably.** Delaware, like most states, will not allow a corporation to nullify the duty of care as completely as this clause purports to do. In particular, this clause would absolve a director from liability even if he knew that the corporate action he was approving violated the law, or even if the director was engaging in self-dealing, and most state courts, including Delaware's, would not allow such a complete waiver of liability. See Del. GCL §102(b)(7), listing a number of wrongs to which an exculpation clause may not apply, including an act or omission that violates the director's "duty of loyalty," that is "not in good faith," or that involves "intentional misconduct or a knowing violation of law."

(b) Yes. Because this clause requires good faith, and doesn't apply if the corporate action is known to be illegal or constitutes self-dealing, the clause meets the requirements of Delaware law (and probably that of most jurisdictions). See Del GCL §102(b)(7), discussed in part (a) above. [190]

Exam Tips on *THE DUTY OF CARE & THE BUSINESS JUDGMENT RULE*

The duty of care — and its sibling, the business judgment rule — are two of the most frequently-tested subjects. Be alert to these issues whenever a fact pattern involves a decision by an officer or the board which could be characterized as ***unwise***.

☛ Never consider "duty of care" in the abstract — always discuss it in ***conjunction*** with the ***business judgment rule***. In other words, phrase the initial issue as "did the directors exercise due care?" but then say something like, "If the conditions for the business judgment rule are met, the court will find that the board satisfied its duty of care even though the transaction turned out badly or seems to the court to have been substantively unwise."

☞ Remember the ***three things*** a director must do to ***qualify*** for the business judgment rule:

❑ she must ***not*** be ***"interested"*** (i.e., have a ***financial stake*** apart from the corp's own interest) in the subject matter of the action;

❑ she must be ***reasonably informed*** about the decision she's making; and

❑ she must ***rationally believe*** that the judgment she's making is in the ***best interests*** of the corp.

- ☞ Remember that ***absent directors*** are held to the same standard as directors who attended the meeting during which the board approved of a particular action. Thus if the board as a whole violated the duty of due care (i.e., didn’t qualify for the business judgment rule), the absent directors will also be liable.

- ☞ Most frequently-tested aspect of the bus. judg. rule: the directors don’t make an ***adequate investigation*** before they ***commit large sums of money*** to a project.

  Example: Pres., the head of Corp., wants to sell Corp. to Acquirer. Pres. is worried that the present demand for Corp.’s products will be transitory, and believes that the most favorable sale would be one that is accomplished rapidly. Therefore, Pres. urges the Corp. board to approve the sale without debate, and does not fully brief the board on the reasons why Acquirer’s offer is the best one that can be gotten. Nor does Pres. or the board have an outsider review the price or other sale terms. The board probably does not qualify for the bus. judg. rule, because it was not adequately informed. If so, the board will be liable for failure to satisfy its duty of care, if its carelessness caused a disadvantageous sale to be made.

  - ☞ A variant is that a report describing the proposed transaction is prepared, but some directors ***don’t read it*** — these directors don’t get the protection of the bus. judg. rule, because they haven’t taken the available steps to make themselves “reasonably informed.”

  - ☞ Questions sometimes involve board ***reliance*** on the ***opinions of others***. Here, the rule is that the board is entitled to rely on others where it is ***reasonable*** to do so. For instance, the board can typically rely on the opinion of the corp’s CPAs, if the latter say that a proposed acquisition is a profitable business that is being sold for a standard multiple of earnings.

- ☞ Also, check whether the directors have acted in ***good faith.*** The requirement of good faith has two main components:

  - ☞ First, the directors must have acted in a ***non-self-interested manner***. If they are acting so as to further their own business interests, at the expense of, say, a minority holder, the directors will not qualify for the bus. judg. rule.

Example: The board refuses to pay out any of $5 million of accumulated earnings as dividends. P, a minority holder, sues to overturn this refusal, and the majority directors defend on the grounds that their dividend policies are protected by the bus. judg. rule. If P can show that the directors' purpose was to "freeze out" P — by depriving him of income so that he'd sell his shares back to the majority at a low price — the directors won't receive the protection of the bus. judg. rule.

☞ Second, the directors ***must not have been aware that they were not discharging their fiduciary obligations.*** (Cite to *Stone v. Ritter* on this point.) At least in Delaware, this means that the directors must have put in some sort of reporting or information system, and must have believed that they were doing some sort of monitoring of data from that system.

☞ A fact pattern will ***rarely fail*** to meet the ***"rational belief"*** requirement for the bus. judg. rule. Remember that so long as the directors' belief that the action was in the corp's interest is not ***wholly irrational***, this prong will be deemed satisfied. And this is true even if the action results in ***financial loss*** to the corp.

Example: To prevent a minority s/h from acquiring control, Corp. buys shares from 3 other s/h's at the asking price of $80/share, a price in excess of both book value and market value. As long as the decision was "plausible," the fact that the judge disagrees about the decision's wisdom — or the fact that later events showed that the shares were not worth the price paid — won't prevent the bus. judg. rule from applying.

[1] “Subjective bad faith” — where the director is “motivated by an actual intent to do harm” — will also qualify as conduct that deprives the director of the benefits of the exculpation provision, according to *Disney*.

CHAPTER 7

THE DUTY OF LOYALTY

ChapterScope

This Chapter covers the duty of "loyalty" owed to the corporation by its directors, officers and controlling shareholders (which we call "Key Players.") Key concepts:

- **Self-dealing transactions:** In a transaction where the Key Player and the corporation are on ***opposite sides*** (e.g., the Key Player sells property to the corporation), the transaction may be voided by the court, and the Key Player required to pay damages to the corporation, unless the conflict is disclosed in advance.
  - ❑ **Approval by disinterested holders or directors:** The best way for the Key Player to avoid self-dealing problems is for her to: (1) ***disclose*** the conflict and the nature of the transaction ***in advance***; and (2) have a majority of the ***disinterested directors*** or ***disinterested shareholders pre-approve*** the transaction after this disclosure.
  - ❑ **Fairness or ratification:** Alternatively, the Key Player will avoid self-dealing problems if either: (1) the transaction is basically ***"fair"*** to the corporation; or (2) disinterested directors or shareholders ***ratify*** the transaction after the fact, after receiving full disclosure about it.
- **Executive compensation:** Decisions about a senior executive's ***salary***, bonuses, stock options or pensions may be overturned if they are ***clearly "excessive,"*** taking into account the nature of the executive's services.
- **Corporate opportunity doctrine:** Before a director or senior executive may take for himself an ***opportunity*** that is likely to be of interest to the corporation (e.g., purchase of some property adjacent to the corporation's property), he must first ***offer that opportunity*** to the corporation. If he doesn't, he may be required to surrender the opportunity to the corporation after the fact, and/or pay damages.

- **Sale of control:** The owner of a controlling block of stock is generally allowed to sell his shares for an above-market ***"premium," without sharing*** that premium with other shareholders. However, there are several exceptions.

I. FIDUCIARY STATUS OF DIRECTORS, OFFICERS AND CONTROLLING SHAREHOLDERS

A. Key Players as trustees: It is sometimes said that directors, officers and controlling shareholders are in effect ***"trustees"*** of the corporation, and have a ***fiduciary obligation*** to it. As Justice Cardozo said (in a case involving a joint venture rather than a corporation, but a case which is often cited in connection with the duties of corporate directors and officers): "Joint adventurers … owe to one another … the ***duty of the finest loyalty***. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place." *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

1. Partial truth: However, the statement that officers, directors and controlling shareholders are in effect trustees of the corporation is only ***partly accurate***. It is true that these Key Players have varying duties to the corporation and its other shareholders that are somewhat similar to the fiduciary duties that a trustee incurs. But there are important differences. For example, a trustee must behave in a prudent manner, whereas the managers of a business enterprise are expected to take risks, sometimes big ones (and often ones that would be inappropriate for a trustee). Similarly, a controlling shareholder may have certain duties to the corporation and to the minority shareholders, but he nonetheless owns his shares, and within fairly broad limits is entitled to sell them when and how he wishes, without concern for the minority; again, this is quite different from the position of the trustee, who must put the interests of the beneficiary ahead of his own interests.

2. **Full-time employee:** There is one situation in which fiduciary responsibilities will be quite strictly enforced in corporate law: any full-time ***employee*** of the corporation (including an ***officer***) is an ***agent*** of the corporation, and is subject to all the fiduciary rules of agency, including a very strict ban on self-dealing.

   a. **Directors and controlling stockholders:** By contrast, an outside director, and a controlling shareholder who is not employed by the corporation, are usually held to at least a somewhat more lenient fiduciary standard. This difference is especially noticeable in the corporate opportunity context (*infra*, p. 219) — a business opportunity that a full-time employee learns about is much more likely to be found to "belong" to the corporation, than is a business opportunity that an outside director or non-employee major shareholder learns about.

II. SELF-DEALING TRANSACTIONS

A. **Kind of transactions we're concerned with:** The first context in which we need to consider the "duty of loyalty" is the context of the ***self-dealing transaction***. The key aspect of such transactions is that the Key Player (officer, director or controlling shareholder) and the corporation are on ***opposite sides*** of the transaction.

1. **Why we're concerned:** More precisely, we're especially concerned with transactions in which ***three conditions*** are met:

   ❑ the Key Player and the corporation are on ***opposite sides***;

   ❑ the Key Player has helped ***influence*** the corporation's decision to enter the transaction; and

   ❑ the Key Player's ***personal financial interests*** are at least potentially ***in conflict*** with the financial interests of the corporation, to such a degree that there is reason to doubt whether the Key Player is necessarily motivated to act in the corporation's best interests.

   See Clark, p. 147. When we use the term "self-dealing transaction" in this book, we'll be referring to transactions that satisfy all three of these requirements.

a. **Sale of property:** For instance, the paradigmatic illustration of the self-dealing transaction is the ***sale of property*** by a director to the corporation, or by the corporation to the director. If the director has influenced the corporation's decision to make the transaction, there is reason to fear that a sale by the corporation to the director will be at too low a price, and a sale by the director to the corporation will be at too high a price.

2. **If transaction with stockholder:** Observe that the fact that the Key Player happens to be a shareholder in the corporation does not remove this danger of unfairness to the corporation. For even though damage to the corporation will hurt the Key Player *qua* shareholder, the gain to him in his role as independent person will probably be greater than the loss to him as shareholder. This is true even if he is the majority shareholder.

> **Example:** Smith owns 70% of the stock of XYZ Corp. He is also president and one of the three directors. XYZ Corp is in the business of building hotels on property that it acquires. Smith happens to own Blackacre, a nice two acre parcel that he and his fellow directors agree is perfect for XYZ to build a hotel on. The board approves XYZ's purchase of the property from Smith at a price of $1 million.
>
> There is reason to worry that this price is too high and is therefore unfair to the corporation. True, if the price is $100,000 too high, Smith will bear $70,000 of this loss (because he owns 70% of the stock). But on the other hand, Smith ends up with $100,000 extra in his pocket, so he is ahead by a net amount of $30,000, and the minority shareholders are behind by $30,000. Since there is reason to think that Smith may have influenced the board's decision even if Smith himself didn't vote on the transaction (the other two directors know that they effectively serve at Smith's pleasure, and that he can decline to reelect them

next time), we have all three ingredients for a self-dealing transaction that should be closely scrutinized: (1) a Key Player in a transaction with the corporation; (2) the Key Player possibly influencing the corporation's decision to enter the transaction; and (3) the Key Player's personal financial interests in conflict with those of the corporation (Smith wants to sell high, the corporation wants to buy low). Therefore, a court will probably scrutinize the transaction fairly closely, and will void it if it appears unfair to the corporation.

B. Historical rule: Courts have gradually become somewhat more tolerant of self-dealing transactions.

1. **Initial rule:** Until the late 1800s, courts were completely uncompromising: self-dealing transactions were ***completely prohibited***. For example, it didn't matter that the transaction was "fair" when viewed by an impartial observer, or that the transaction purported to have been approved by a majority of disinterested directors with full knowledge of the facts.

2. **Fair and ratified transactions:** By 1910, most courts had eased that prohibition somewhat: a self-dealing transaction would be allowed to stand if it was ***both*** approved by a majority of fully-informed disinterested directors, and was "fair" to the corporation (as determined by the court). But a contract in which a ***majority*** of the board was interested was voidable even if fair.

3. **Modern view:** By 1960, the still more liberal view that generally applies today was in place: a self-dealing transaction found by the court to be ***fair*** would be ***upheld***, whether approved by a disinterested board or not. (In most states, the rule is at least partly established by statute.)

   See generally Clark, pp. 160-61.

4. **Rationale:** The cases give no clear explanation for this dramatically increased tolerance for at least those self-dealing transactions that are found to be fair. Probably much of this tolerance comes from recognition that there will generally be an

economic benefit to the corporation from allowing fair but self-dealing transactions — especially in the case of the close corporation (see *supra*, p. 133), transactions between a Key Person and the corporation may be the ***only way*** a corporation can obtain funds, goods or other things it needs.

Example: Suppose that Close Corp. is formed by three shareholders, A, B and C. The corporation needs working capital to pursue its business (a service business which so far has no tangible assets). Banks are unwilling to lend to Close. A and B cause a corporation that they control to make an unsecured loan to Close at the prime rate. The transaction is never approved by the sole disinterested director, C, and it is never formally ratified by the stockholders acting as such.

In the late 1800s or even 1910, a court would have voided the transaction at C's request, without considering its fairness to Close. But a modern court would probably determine that it was fair to the corporation (since it was not at an excessively high interest rate, and no better terms seemed to be available from other sources), despite the lack of direct approval by disinterested directors or shareholders. The reason is that the transaction has been beneficial to Close, since it enabled it to get funds that it could not otherwise easily obtain.

C. Modern rule in detail: Let us now consider in more detail the modern rule. You must keep in mind that there is substantial variation among states, and that we are merely trying to summarize the view of ***most*** courts.

1. Statement of rule: Most courts, acting by a combination of statutory interpretation and common-law principles where the statute is silent, seem to divide self-dealing transactions into three categories:

a. Fair transactions: If the transaction is found to be ***fair*** to the corporation, considering all the circumstances, nearly all courts will ***uphold*** it. This is true ***whether or not the***

transaction was ever approved by disinterested directors or ratified by the share-holders.

b. Waste/fraud: If the transaction is so one-sided that it amounts to ***"waste"*** or ***"fraud"*** against the corporation, the court will usually ***void it*** if a stockholder complains. This is true even though the transaction has been approved by a majority of disinterested directors (acting with full knowledge of the transaction they were approving) or ratified by the shareholders.

c. Middle ground: If the transaction does not fall into either of these categories — the court is not convinced it's perfectly fair, but the unfairness does not amount to waste or fraud — the court's response will probably depend on whether there has been ***director approval*** and/or ***shareholder ratification***. If a majority of disinterested and knowledgeable directors have approved the transaction, the court will probably uphold it; the court will similarly uphold it if it has been ratified by the shareholders. If neither disinterested director approval nor shareholder ratification has occurred, the court will probably invalidate the transaction. The ***burden of proof*** is on the ***Key Player***; he must show that the transaction was approved by either: (1) a disinterested and knowledgeable majority of the board ***without participation by the Key Player***; or (2) a majority of the shareholders ***after full disclosure*** of the relevant facts.

2. Summary: Thus the most important variable in the modern cases seems to be ***fairness***; clearly-fair transactions are always upheld, clearly-abusive ones (waste or fraud) are always struck down, and only if the transaction's fairness is ambiguous will the fact of disinterested director approval or shareholder ratification make a difference. See generally, Nutshell, p. 321.

3. MBCA: The corporation statutes of 38 states have explicit provisions dealing with transactions between the corporation and a Key Player. Most of these statutes deal solely with contracts between the corporation and a ***director***, not those between a corporation and a non-director officer or controlling shareholder. Probably the most important, and explicit, such statute is MBCA §§8.60-8.63. These sections were made part of the MBCA in 1988, replacing a much simpler single provision. Although these new sections have so far not been widely adopted by the states, they are likely to become increasingly influential.

a. **Typical approach:** Also, the general pattern of these MBCA provisions — that a self-dealing transaction will be upheld if it is either approved by disinterested directors, ratified by shareholders or found by a court to have been fair — is typical of the approach of most states. Therefore, we consider the MBCA provisions in some detail. §§8.60-8.63 are usually collectively referred to as "Subchapter F" of the MBCA.

b. **Key section:** The key section of the MBCA Subchapter F is §8.61:

> **§8.61 Judicial Action**
>
> (a) A transaction effected or proposed to be effected by a corporation (or by an entity controlled by the corporation) may ***not*** be the subject of ***equitable relief*** or give rise to an ***award of damages*** or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an ***interest*** in the transaction if it is ***not a director's conflicting interest transaction***.
>
> (b) A ***director's conflicting interest transaction*** may ***not be the subject of equitable relief,*** or give rise to an ***award of damages*** or other sanctions against a director, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an ***interest respecting the transaction*** if:
>
> (1) ***directors' action*** respecting the transaction was taken in compliance with section 8.62 at any time; or
>
> (2) ***shareholders' action*** respecting the transaction was taken in compliance with section 8.63 at any time; or
>
> (3) the transaction, judged according to the circumstances at the relevant time, is established to have been ***fair to the corporation***.

c. **Definitions:** Section 8.60 supplies a set of definitions for Subchapter F; these definitions are too long and convoluted to be reproduced here in full. However, we discuss a few of the definitions here.

i. **"Director's conflicting interest transactions":** The core definition is that of "Director's conflicting interest transaction," defined in §8.60(1) as follows:

> (1) ***"Director's conflicting interest transaction"*** means a transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)
>
> (i) to which, at the relevant time, ***the director is a party***; *or*
>
> (ii) respecting which, at the relevant time, the ***director had knowledge and a material financial interest known to the director***; or
>
> (iii) respecting which, at the relevant time, the director ***knew that a related person was a party or had a material financial interest***."

ii. "Related person": Another key definition is ***"related person."*** Under §8.60(5), a "related person" encompasses principally the director's spouse, child, grandchild, sibling or parent (or any of these people's spouses), or any trust or estate as to which the director is a beneficiary or fiduciary. But the concept also includes any ***business or non-profit of which the director in question is a director or partner.***

iii. "Material financial interest": Next, there is a definition of ***"material financial interest"***: this means "a financial interest in a transaction that would reasonably be expected to impair the objectivity of the director's judgment when participating in action on the authorization of the transaction." §8.60(4).

iv. "Required disclosure": Finally, there is a definition of ***"required disclosure,"*** which means "disclosure of (i) the ***existence and nature of the director's conflicting interest***; and (ii) all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would ***reasonably believe to be material in deciding whether or not to proceed with the transaction."*** §8.60(6).

v. Explanation: Integrating these definitions: no matter whether the transaction involving the corporation is major or minor, it's automatically a "director's conflicting interest transaction" if *either* of the two following things is true:

[1] the director in question, or her ***close relative*** (or a business entity or non-profit that either the director or her close relative controls or ***serves as a director***) ***is a party*** to the transaction; or

[2] the director or her close relative (or a business entity or non-profit that either the director or her close relative controls or serves as a director) has (and knows she has) a ***"material financial interest"*** concerning the transaction.

> **Example of [1] (D is a party):** A director (call him "D") of X Corp. uses his influence to cause the board of X Corp to authorize the purchase of $1,000 worth of office supplies from Z Corp., of which D is also a director. D is a multimillionaire, and does not benefit (or think he will benefit) in any way from the sale of supplies. Because D is a director of Z Corp., Z Corp. is a "related person" to D. D does not disclose to X's board that D is a director of Z Corp.
>
> Since a related person to D is a direct party to the transaction with X Corp., the sale of supplies is a "director's conflicting interest transaction" as to D. Therefore (as we'll see in the next section entitled "three-part approach"), under the MBCA the court may enjoin it, or award damages against D in connection with it, if it's not approved by the Board or the shareholders of X Corp. after proper disclosure by D of his interest, and is "unfair" to X. So, for instance, if X is overcharged by $400, under the MBCA X can be required to pay the $400 back to X Corp. in damages, even though the small size and D's wealth meant that he did not have a "material financial interest" in the transaction. In other words, the fact that a "related person" to D (i.e., Z Corp.) was a party *automatically* made the transaction a "director's conflicting interest transaction" as to D.
>
> **Example of [2] (D has a "material financial interest" but is not a party):** D (again a director of X Corp.) suggests to X Corp's board that X Corp. should purchase, for $1 million, a parcel of vacant land from Sell, an individual. Sell is not a "related person" to D. However, unbeknownst to any other board member or executive of X Corp., not only are D and Sell good friends, but prior

to the transaction Sell has promised D that if Sell is able to sell the property for $1 MM to X Corp., then Sell will pay a $50,000 "commission" to D.

This quid pro quo has almost certainly given D a "material financial interest" concerning the purchase of the parcel from Sell (since the prospect of receiving a $50,000 fee "would reasonably be expected to impair the objectivity of the director's judgment when participating in action on the authorization of the transaction," the standard for whether the director has a "material financial interest.") If so, then under the MBCA a sale authorized by X Corp's board is a "director's conflicting interest transaction" as to D. Consequently, if D does not disclose the conflict and then get the transaction approved either by the Board or the shareholders of X Corp., then unless the transaction is "fair" to X Corp., a court acting under the MBCA could either enjoin it or award damages against D. And that's true even though D is not directly a party to the transaction — D's having a "material financial interest" is a substitute for D's being a party to the transaction. (The same would be true if, say, it was a *sibling or child* of D who would get the commission — if a "related party" to the director has a material financial interest in the transaction, it's the same as if the director himself had such an interest.)

d. Three-part approach: The guts of Subchapter F are set forth in §8.61 (reproduced above). That section imposes two major rules:

i. Non-conflict transactions: Where a transaction is "***not*** a director's conflicting interest transaction" (under the definitions summarized in (c) above), the court may ***not*** enjoin it or set it aside on account of any interest which the director may have in the transaction.

ii. Conflict transactions: If the transaction ***is*** a "director's conflicting interest transaction," the corporation and the director receive a ***"safe harbor"*** for the transaction — and the court may thus not set it aside — if: (1) a ***majority of disinterested directors approved it*** after disclosure of the conflict to them (§8.62); or (2) a majority of the votes held by ***disinterested shareholders*** are cast in a vote ***ratifying*** the action, after disclosure of the conflict (§8.63); or (3) the transaction, "judged according to the circumstances at the time of commitment, is established to have been ***fair*** to the corporation."

e. Commentary: Here are several aspects of Subchapter F that may not be obvious:

i. Exclusive definition of "conflicting interest": First, the definition of "director's conflicting interest transaction" given in §8.60 is ***exclusive***. That is, if the transaction does ***not*** fall within the definition given there, the transaction is automatically deemed ***non-conflicting***, and the court may not overturn it on grounds of director self-interest.

Example: D is a director of X Co. X Co. proposes to enter into a transaction with Smith, who is D's cousin. The transaction comes before the X Co. board for approval. D and Smith are not only cousins but extremely close friends, and D knows that Smith desperately needs the money which would come to him as the result of the proposed transaction. D does not disclose to the X Co. board the fact that Smith is his cousin, or that D wishes the transaction to go forward so as to aid Smith. D has no independent financial interest in the transaction. The board members listen to D's urging that the transaction be approved, and vote for approval. P, a shareholder, now sues the board and Smith, seeking to have the transaction set aside.

Under the MBCA approach, the court must conclude that there is *no conflict*, and may therefore not even consider overturning the transaction on conflict grounds. The reason is that a cousin is not "related person" under the definitions given in §8.60(5), and D had no direct financial interest of his own in the transaction. Since the transaction is not a "director's conflicting interest transaction" as defined in

§8.60(1), §8.61(a) requires that the court not enjoin it on account of any conflict arising out of the X-Smith relationship. (This example is suggested by an example given in Official Comment 1 to §8.61.)

ii. Directors only: Second, Subchapter F covers only transactions between the corporation and one of its ***directors***. Transactions between the corporation and a non-director ***officer or shareholder*** are not covered by Subchapter F (and are in fact not covered by ***any*** provision of the MBCA having to do with self-dealing). Thus transactions with non-director officers or shareholders under the MBCA are left entirely to ***common-law principles*** (though the court is likely to approach these in almost the same way as a transaction between the corporation and a director).

iii. Disclosure after controversy: Third, the disclosure and approval can happen even ***after the transaction has been challenged*** by a dissident shareholder or third party. In other words, after-the-deal ***ratification*** by the board can suffice — pre-approval is not necessary. See Official Comment to MBCA §8.62(a).

Example: A majority of disinterested directors approve Corp's purchase of land from Landco, a limited partnership. At the time of the approval vote, the directors don't know that Bob, one of the directors, is secretly a major partner in Landco. The purchase goes through. Steve, a minority holder in Corp., then learns of the conflict. He brings a derivative suit to have the transaction unwound. If nothing further happens (and if the court finds that the transaction was "unfair" to Corp.), the court will probably order the transaction unwound or at least order that Bob pay damages to Corp. But if, within a reasonable time after Steve brings suit, the board ratifies the transaction with full disclosure of the nature of the transaction and nature of Bob's ownership interest in the selling partnership, the court will not interfere.

4. Three paths: Under the MBCA and the statutes of most states, there are thus three different ways that proponents of a self-dealing transaction can avoid invalidation:

[1] by showing that it was ***approved by a majority of disinterested directors***, after full disclosure;

[2] by showing that it was ***ratified by shareholders***, after full disclosure; and

[3] by showing that it was ***fair when made***.

Let’s now consider each of these branches in detail in Paragraphs D, E and F below.

D. Disclosure plus board approval: The general principle behind the “board approval” branch is simple to state: a ***transaction may not be avoided by the corporation if it was authorized by a majority of the disinterested directors, after full disclosure of the nature of the conflict and the transaction***. However, this formulation raises a number of questions:

1. What must be disclosed: ***What information*** is it that must be disclosed to the disinterested directors? Most courts (and the MBCA) require disclosure of ***two*** major kinds of information: (1) the material facts about the ***conflict***; and (2) the material facts about the ***transaction***.

a. Conflict: Often the fact that there is a conflict will be obvious to the disinterested directors (e.g., when the contract runs directly between the director and the corporation). But other conflicts will not be obvious, and must therefore be disclosed by the Key Person. This will be true, for instance, if the other party to the transaction is a ***corporation*** in which the Key Person has a significant pecuniary interest. (See the discussion of indirect conflicts, *infra*, p. 209.)

Example: XYZ Corp wants to buy an office building. D, a vice president of XYZ, owns all of the stock of Realty Corp, which owns an office building. D has a real estate broker offer the building to XYZ, and the board of XYZ votes to acquire it. The other directors are not aware that D has an interest in Realty Corp.

Even though all material economic facts about the underlying transaction (e.g., the condition and market value of the building) have been disclosed to the other board members, approval by the board of the contract will not insulate the transaction from attack, because D has not disclosed his financial interest in Realty Corp to the board. See MBCA §8.62 (requiring disclosure to the board, before approval, of details regarding the director's conflict); §8.60(6) (defining the required disclosure).

b. Disclosure of transaction: Apart from disclosure of the facts that cause a conflict, the Key Person must also disclose all facts about the ***underlying transaction*** that a reasonable observer would consider ***"material."*** This obligation goes far beyond the ordinary duty of one party to a contract to disclose essential facts to the other. For instance, if the Key Person knows of facts that are likely to make the proposed contract turn out to the disadvantage of the corporation, ***he must disclose those facts***, whereas a third party negotiating at arm's length with the corporation could remain silent.

c. When disclosure must be made: You might think that the requirement of disclosure means that the disclosure must take place ***before*** the transaction is entered into. But courts are in fact in disagreement about whether this is required.

i. Ratification allowed: Some courts will uphold the transaction based on board approval even if the disclosure does not come ***until*** after the transaction is entered into, so long as the directors then ***"ratify"*** it (by formally stating that they have no objection, or perhaps even by simply failing to raise an objection). Thus MBCA §8.61(b)(1) insulates the transaction against judicial review if "directors' action respecting the transaction was ***at any time*** taken in compliance with §8.62" (providing for approval by disinterested directors). The phrase "at any time" is intended to allow for post-transaction ratification.

ii. **Contrary view:** But other courts require the disclosure to occur before the transaction, or at least make it tougher for transactions to be ratified after the fact instead of approved beforehand.

2. **Who is a "disinterested" director:** The approval must be by a majority of the ***"disinterested"*** directors. Who is "disinterested" for this purpose? Most courts would probably agree with the MBCA, which says that a director is "qualified" (the MBCA's term for "disinterested") if (i) the transaction is not a "director's conflicting interest transaction" (see *supra*, p. 201 for what this means); *and* (ii) the director does not have a "material relationship" with another director as to whom the transaction is a "director's conflicting interest transaction." MBCA §1.43(a)(3).

Example 1: The proposed transaction is between X Corp. and Z Corp., under which X Corp. will buy a piece of real estate from Z Corp. The issue is whether D, a director of X Corp., is "disinterested" (or under the MBCA, "qualified"), so that D's vote to approve the transaction can contribute to the required approval by a majority of disinterested directors. Assume that D is also a director of Z Corp. D is not qualified, because under the combination of MBCA §§8.60(1)(iii) and 8.60(5)(v), D's being a director of Z Corp. makes Z Corp. a related person to D, and the fact that D has a related person who has a "material financial interest" in a transaction makes the transaction a "director's conflicting interest transaction" as to D.

Example 2: Same basic facts as above example. Now, however, D has no direct relationship with Z Corp. However, D's boss, B, who also happens to be on X Corp's board, is a director of Z Corp. Since D has a material relationship with B (boss-subordinate would almost certainly be a material relationship), the fact that the transaction is a director's conflicting interest transaction as to B means that D, too (not just B) is not a disinterested or qualified director.

a. **Outside professionals:** Even outside directors who serve as ***professionals*** (e.g., outside counsel or outside accountant) to the corporation may be found to be "interested" in a transaction in which the CEO is a party. The theory for treating these professionals as "interested" is that they may be afraid they will no longer be engaged by the corporation if they annoy the CEO by voting against the transaction. Thus on the facts of Example 2 above, if D was not B's subordinate, but was instead a lawyer who relied on B for lots of business, D would likely not be disinterested.

3. **Quorum:** Often, especially in the case of a close corporation, a majority of the directors will be "interested" in the transaction. (For instance, the CEO may be a party to the transaction, and a majority of the directors may be full-time employees who owe their jobs to him.) In this situation, there will of course not be enough disinterested directors to constitute a quorum of the board. Therefore, a special rule exists in almost all states to facilitate approval by the disinterested directors: if a ***majority of the disinterested directors*** approve the transaction, this constitutes not only approval, but also a ***quorum***. (However, most statutes require ***at least two*** disinterested directors to approve the transaction.) See MBCA §8.62(c), and Del. GCL 144(a)(1), both to this effect.

> **Example:** The board of XYZ Corp has five directors. Two of them propose to enter into a contract with XYZ, and are therefore interested directors. The other three are not interested. One of the three disinterested directors is absent from the board meeting. The other two disinterested directors are sufficient to constitute a quorum for approval purposes (since they represent a majority of the three disinterested directors). If these two approve the transaction, this will constitute the requisite disinterested-director approval.
>
> If, on the other hand, two of the three disinterested directors were absent, the third director's vote approving the transaction would not constitute either a quorum or

approval, because there would not be approval by a majority of the total disinterested directors (those present and those absent).

4. **Presence or vote of interested director:** Ideally, the ***interested*** director should ***abstain*** from either voting or even lobbying the disinterested directors concerning the transaction. However, most statutes provide that participation by the interested director in the consideration or voting does ***not*** by itself nullify the approval by the disinterested directors — the interested director's presence and/or vote is simply ***disregarded***, and the sole question is whether a majority of the total disinterested directors has approved the transaction.

   a. **Different rule in MBCA:** But some statutes say that ***no interested director(s) may be either present or voting*** (presumably for fear that the interested director's mere presence may sway the others.) See, e.g., MBCA §8.62(a)(1), which says that a vote by the disinterested directors authorizing the transaction will be effective only if the disinterested directors "have deliberated and ***voted outside the presence of and without the participation by*** any other [i.e., interested] director."

5. **Committee:** Under most statutes, approval by disinterested directors may be done at the level of a ***committee*** rather than the full board. Usually, this committee may be either one that already exists (e.g., the compensation committee), or one appointed specially to consider the particular transaction. In any event, all that is required for a quorum and for approval is the approval by a majority of the disinterested directors ***on the committee***, even if this is less than a majority of the total disinterested directors on the board.

6. **Immunization of unfairness:** Suppose a majority of disinterested directors (acting after full disclosure of all material facts) approves a transaction that, viewed later by a court, is clearly ***unfair*** to the corporation. Does the disinterested-director approval completely immunize the transaction against attack for

self-dealing? Most statutes are written as if the answer were ***"yes."*** However, in practice courts often void such transactions if the unfairness is great, despite the disinterested-director approval; frequently, they accomplish this result by finding that the transaction constituted "waste." (The effect of unfairness is discussed more extensively, *infra*, p. 208.)

a. **Shifting of burden of proof:** In most states, approval by the disinterested directors does seem to at least ***shift the burden of proof***: if the transaction has not been approved by disinterested directors (or shareholders), the burden is generally on the Key Player to prove that it was fair; once approved by disinterested directors, the burden shifts to the person attacking the transaction to show that it was unfair. See *infra*, p. 209.

E. **Disclosure plus shareholder ratification:** The second main branch for validating a self-dealing transaction is the ***ratification by shareholders***, following disclosure to them.

1. **Disclosure required:** As in the case of disinterested-director approval, the shareholder ratification will be effective only if it comes after there has been ***full disclosure*** to the shareholders of ***both the conflict*** and the ***material facts of the transaction itself***.

2. **Disinterested shareholders:** Recall that in the case of director authorization, a majority of the ***disinterested*** directors must approve. Does a comparable rule apply to shareholder ratification, or may interested shareholders vote and be counted towards a majority? The courts are hopelessly ***split*** and confused about this issue — some seem to say that shareholder ratification has no effect unless a majority of the disinterested shareholders approve, whereas others seem to hold that all shareholders may vote and be counted. A court is likely to give a more searching inquiry into the transaction's underlying ***fairness*** (*infra*, p. 208) in those situations where it is not clear that a majority of the disinterested shareholders has approved.

a. **MBCA:** The MBCA takes a stringent view: under §8.63(a), a majority of the ***disinterested*** shareholders must approve the transaction. (On the other hand, for purposes of determining whether the transaction is approved under general corporate action principles having nothing to do with the conflict, interested shareholder votes may be counted, and are part of the quorum.)

Example: Assume that Parent Corp owns 60% of Subsidiary Corp. Parent Corp wants to merge Subsidiary Corp into itself. Because Parent Corp is a party to the transaction, the conflict will be deemed ratified by the shareholders only if at least half of the holders of the minority block approve it, under MBCA §8.63(a) and (c). See Official Comment 3 to MBCA §8.63. However, for purposes of determining whether the general requirement of shareholder approval for *any* merger under the MBCA has occurred, and for determining whether there has been a quorum for that approval, Parent Corp's votes may be counted.

F. Fairness as the key criterion: The final method of defending a self-dealing transaction against attack is by showing that it is, under all the circumstances, ***fair*** to the corporation.

1. Fairness alone sufficient: In nearly all states, ***fairness alone*** will cause the transaction to be ***upheld***, even if there has been ***no approval*** by disinterested directors and no ratification by shareholders.

a. Measured at time of transaction: "Fairness" is generally determined by the facts as they were ***known at the time of the transaction***. See, e.g., MBCA §8.61(b)(3) ("judged according to the circumstances at the relevant time[.]")

2. No requirement of prior disclosure: In most courts, the transaction will withstand attack if it is proven fair, even though ***no disclosure whatsoever*** is made by the Key Player to his fellow executives, directors or shareholders. Thus in the office building example on p. 205 *supra*, even if D never disclosed to anyone that he was a controlling shareholder in the firm that owned the building being sold to the corporation, most courts would hold that so long as the pricing terms were in line with what would have been produced by arm’s length bargaining, the transaction may not be avoided by the corporation.

3. **Authorization/ratification does not immunize from unfairness:** In most states, fairness is really the ***key element***. As we’ve just seen, if the transaction is fair, lack of disinterested-director authorization or shareholder ratification will not make a difference. Conversely, if the transaction is found by the court to be grossly ***unfair***, under most statutes the fact that there *was* approval by disinterested directors, or ratification by shareholders, will ***not immunize*** the transaction.

   a. **Delaware allows immunization:** But some jurisdictions, probably a minority, do allow disinterested-director authorization or shareholder ratification to ***immunize*** even an unfair transaction from judicial review. Delaware, for instance, seems to allow such immunization. As the Delaware Supreme Court has stated: “Approval by fully-informed disinterested directors under §144(a)(1), or disinterested stockholders under §144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste, with the burden of proof upon the party attacking the transaction.” *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987).

   b. **MBCA allows immunization:** Similarly, the MBCA forbids judicial review of the fairness of director-authorized or shareholder-ratified transactions. §8.61(b) (as noted *supra*, p. 201) states that the court may not overturn a director-conflict transaction if the action was authorized by disinterested directors after disclosure, or ratified by disinterested shareholders after disclosure.

4. **Significance of director or shareholder approval:** If fairness is what really counts — that is, if fair transactions will be upheld even without director or shareholder approval, and unfair ones will be struck down even with shareholder or director approval — why bother to get approval by disinterested directors or by

shareholders? The answer is that in most states, there is still some practical benefit to this kind of approval, a benefit which stems from ***standards of proof*** and the ***burden of proof***.

a. **Standards of proof:** First, in most states, the ***degree of unfairness*** that must be shown to upset a transaction that has been approved by disinterested directors or shareholders is probably ***greater*** than where there has been no approval. Some courts accomplish this by saying that a director-approved or a shareholder-approved transaction will only be overturned if the unfairness is so great that it amounts to ***fraud*** or ***waste***. Others appear to look for "gross" unfairness, as opposed to the "ordinary" unfairness that will be enough for invalidation where there has been no approval.

b. **Burden of proof:** Second, the ***burden of proof shifts*** in most states when there has been director or shareholder approval. Without such approval, the burden of proof is clearly on the ***Key Player*** to show why the transaction is fair. Once there has been disinterested-director approval or shareholder approval, the burden shifts to the person who is attacking the transaction, who must now come forward with evidence of the transaction's ***un***fairness. Most statutes do not expressly document this shift in the burden of proof, but courts seem to make the shift anyway.

G. **Indirect conflicts involving Key Player:** So far, we've generally assumed that the Key Player is himself directly a party to the transaction in question. But the rules against self-dealing also apply where the conflict of interest is ***"indirect."*** That is, self-dealing problems arise where the Key Player has an interest or association with ***some other entity***, and it is that entity that enters into the transaction with the corporation.

1. **Pecuniary interest:** In general, if a Key Player's ***financial interest*** in the other entity is such that this interest would reasonably be expected to ***affect his judgment*** concerning the transaction, the self-dealing rules apply. For instance, if the Key Player is a significant ***stockholder*** of the other corporation, or a

partner in a partnership, the transaction involving that other corporation or partnership will be deemed self-dealing, and the rules described above will apply. The office building hypothetical on p. 205 is an example of this principle.

2. **Interlocking directors and other non-ownership problems:** Suppose the Key Player does not have a significant ownership interest in the other entity, but is a full time ***executive*** or a ***director*** of that other entity. Here, the self-dealing problem is usually thought to be less severe, so the full range of self-dealing rules does ***not*** apply. For instance, the fact that a person serves on the board of directors of both companies (the ***"interlocking directorate"*** problem) will not by itself usually cause a transaction between the two companies to constitute self-dealing by the director.

   a. **MBCA is different:** But again, in this interlocking-directorate scenario the MBCA is ***much stricter*** than the usual state statute. One of the ways a transaction will be a "director's conflicting interest transaction" is if the director "knew that a related person was a party or had a material financial interest" in the transaction. MBCA §8.60(1)(iii). "Related person" is defined in §8.60(5)(v) to include "a domestic or foreign … business … of which the director is a director." So a person who is a director of both corporations is not, under the MBCA, a disinterested (or "qualified," to use the MBCA's term) director as to any transaction between the two corporations.

      Example: D is a director of A Corp and B Corp. A Corp. proposes to buy a piece of real estate from B Corp. When A Corp's board votes on the transaction, D will not be a "qualified" (i.e., disinterested) director, because he is a director of a related person (related to him, that is) — B Corp — and that related person is a party to the proposed transaction. Therefore, D must be careful to make disclosure of his conflict, and then not participate (or be present at) the vote by A Corp's board.

H. Remedies for violation: Where there has been a violation of the rule against self-dealing, there are two possible ***remedies***: (1) ***rescission***; and (2) ***restitution*** in the form of money damages. The plaintiff will normally be the ***corporation itself***, or a shareholder who has brought a derivative suit (*infra*, p. 318) in the corporation's name.

1. **Rescission:** If it is possible to ***rescind*** the transaction, this is normally the appropriate remedy for self-dealing. For instance, in the office building sale hypothetical (*supra*, p. 205), if suit were brought by the corporation or a shareholder in a derivative suit, and the closing had not yet occurred, the court would simply order that the contract be cancelled. If there is to be rescission, the corporation must ***give back*** any consideration it has received in the transaction. For instance, if the corporation has sold corporate property to a Key Player in what turns out to be an unfair transaction, the corporation may obtain return of the property, but it must then return to the Key Player the price he paid.

2. **Restitutionary damages:** If because of the passage of time or the complexity of the transaction, it is not feasible to rescind it, the appropriate remedy is ***restitutionary damages***. That is, the Key Player will be required to pay back to the corporation any benefit he received beyond what was fair. For instance, in our office building sale hypothetical (*supra*, p. 205), if Realty Corp received $1 million for the sale of the building, and the fair market price was only $800,000, D or Realty Corp would have to return to XYZ the $200,000 excess over fair value.

3. **Consequence:** Observe that neither rescission nor restitution is a very strong deterrent to self-dealing: In either case, the Key Player who has engaged in the wrongful self-dealing is merely ***returned to the same position*** he would have been in had he not done the transaction at all. See C&E, pp. 662-63. However, some courts have ordered the self-dealing Key Player to also return any ***salary*** he earned during the relevant period, have awarded ***punitive*** damages to the corporation, or have ordered the self-dealer to pay the corporation's ***counsel fees*** and other litigation

expenses. C&E, pp. 663-64.

Quiz Yourself on ***THE DUTY OF LOYALTY*** *(SELF-DEALING TRANSACTIONS)*

47. Mr. Haney is one of six directors of the Green Acres Produce Company. Green Acres is interested in expanding its acreage. It wants to buy a 100-acre tract of land in Hooterville, which is owned by the Hooterville Limited Partnership. When the chairman of Green Acres Produce, Oliver Wendell Douglas, inquires as to a selling price, Hooterville's general partner, Mr. Ziffel, tells him it's $10,000 an acre. Mr. Haney doesn't go to the directors' meeting where the land purchase is discussed; the other five directors approve it unanimously. Unbeknownst to the other board members, Mr. Haney is one of the limited partners in the Hooterville Limited Partnership (he owns a 25% economic interest in the partnership). A minority shareholder of Green Acres finds out about the proposed purchase, and sues to prevent its consummation, on account of the fact that Mr. Haney is arguably on both sides of the transaction. Assume that the proposed price is 30% above market prices for the type of property in question, and that the Hooterville directors who voted in favor of the transaction knew this. Does the fact that the disinterested directors approved the transaction mean that the court should allow the transaction to go forward? ___________________________

48. The Addams Shroud Company provides funeral supplies. It has seven directors — Gomez, Morticia, Puggsley, Wednesday, Fester, Lurch, and Cousin Itt. Of the seven, four of them — Gomez, Morticia, Wednesday, and Puggsley — are also major shareholders of the Arsenic and Old Lace Fabric Company, which makes, among other things, black fabric. The Addams Shroud Company uses a lot of black fabric that it buys from various suppliers. Gomez negotiates a requirements contract on Addams Shroud's behalf with Arsenic and Old Lace. When it comes time for the Addams's board to approve the contract, the four "interested" directors abstain (after making sure that the others know the full details of the conflict and of the contract). The three remaining directors vote, 2-1, to approve the contract. The dissenter argues that the contract has not been properly approved, because a quorum of the board did not participate in the decision. Has the Addams's board properly approved the contract, in a manner that will immunize the contract from attack on conflict grounds? ___________________________

49. The Enterprise Tribble Company makes funny toys called, predictably enough, tribbles. James Kirk is one of the five directors of Enterprise. He is also majority shareholder of Romulan Card Stores, a chain of greeting card and novelty toy stores. Kirk believes that Romulan can sell Enterprise's entire tribble output. Romulan and Enterprise negotiate a contract, whereby Romulan agrees to pay $5 per tribble (a fair price based on what the parties know at the time), for two years, for 1,000,000 tribbles per year (which is likely to be most of Enterprise's output). Kirk fully discloses his conflict and the material elements of the contract to the other, disinterested members of the Enterprise board, who unanimously approve the contract. It comes as a surprise to everyone when tribbles feature prominently in a Star Trek episode shortly after the contract goes into effect, such that the demand for tribbles — and the price Romulan can charge for them — skyrockets. A minority shareholder of Enterprise, Scotty, can't take it any longer, and files a derivative lawsuit against Kirk, citing the unfairness of the deal and seeking to void it on grounds of conflict of interest. What result? ___________________________

Answers

47. No, because Mr. Haney didn't disclose his ownership interest in the land to the board. This was a director-conflict situation: Haney was a director of the buyer, and he also had a sufficiently large financial interest (25%, or $250,000) in the subject of the transaction that his impartiality can reasonably be questioned.

When a director has a conflict of interest involving a corporate transaction, there are three ways to avoid the transaction's voidability on conflict grounds: (1) full disclosure and disinterested director approval, (2) full disclosure and shareholder approval, or (3) overall fairness. (In practice, most courts require that the transaction be fair regardless of director or shareholder approval.) But the conflict won't be deemed to have been "disclosed" unless the disinterested directors (or shareholders) knew *both* the nature of the transaction *and* the *nature of the conflict*. See, e.g., MBCA §8.62(a) (making board approval of a conflict transaction effective only if it comes after "required disclosure") and §8.60(6) (defining "required disclosure" as disclosure of (i) "the existence and nature of the director's conflicting interest" and (ii) "all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether or not to proceed with the transaction.")

Here, the disinterested directors didn't know that Haney was a significant partner of the selling entity, so they didn't know of the "nature of the director's conflicting interest." Therefore, there wasn't true disclosure, and the approval by the disinterested directors will be irrelevant. (It's also irrelevant that Haney didn't vote on the proposed transaction — as long as there was a conflict between Haney's role as director of Green Acres and his role as partner in Hooterville, the conflict rules apply, requiring disclosure.)

In fact, full disclosure would probably require not only that the Green Acres board be told that Haney was a partner in Hooterville, but also that the board be told the approximate size of his interest (e.g., that he owned about 1/4 of the economic interest.)

Observe that if the transaction were "fair" to the corporation, the court would probably approve it even without the prior disclosure; but the facts tell you that the price is quite high, thus making it probably unfair. Also, note that even *after the dissident shareholder filed suit*, under most conflict statutes it would not be too late for Haney to make full disclosure, and procure a truly informed approval by the disinterested directors. (See, e.g., Off. Comm. to MBCA §8.62(a)). Such an after-the-fact vote would suffice to immunize the transaction from a court-issued injunction or an award of damages.

48. **Yes.** The contract will not be voidable on conflict grounds, because a majority of the disinterested directors have approved it after full disclosure.

A conflict arises when a director or officer has split loyalties. Here, the conflict is indirect — four Addams directors are shareholders of a corporation with which Addams Shroud is contracting. The prevailing rule is that such a contract is voidable at Addams's option unless either disinterested directors approve it on full disclosure, shareholders approve it on full disclosure, or it's fair. Most states hold that as long as a majority of the disinterested directors (with a 2-person minimum) approve the transaction, this counts not only as approval, but also as a quorum. See, e.g., MBCA §8.62(c). Since a majority of the 3 disinterested directors have approved, this condition is satisfied. [206]

49. **The deal isn't voidable, because it was approved by disinterested directors, and, besides, it's fair.** The transaction here involves a conflict because Kirk is a director for one party to a contract and majority shareholder of the other. The general rule is that such a contract is voidable unless either: (1) the transaction and conflict are disclosed to directors, who approve it; (2) the transaction and conflict are disclosed to shareholders, who approve it; or (3) it's fair to the corporation. [200] Here, Kirk fully disclosed the material facts of the deal and the conflict to the disinterested directors of Enterprise, who approved it. This satisfies test (1), and is thus in and of itself enough to avoid voidability on grounds of conflict.

    In any event, the transaction here was "fair" to Enterprise. A court will generally judge fairness as of the time the transaction was made. (See, e.g., MBCA §8.61(b)(3)). [208] At the time this deal was made, everything suggested that the deal was fair to Enterprise. So the transaction satisfies (3), and would therefore not be voidable at Scotty's urging even if full disclosure and pre-approval by the board *hadn't* occurred.

III. EXECUTIVE COMPENSATION

A. Aspect of self-dealing: We turn now to what might be thought of as a "special case" or aspect of self-dealing, ***executive compensation***. When an executive is sufficiently senior that he can influence the corporation's decision on his compensation, we have a transaction that presents all the traditional dangers of self-dealing: since the executive is to some extent on both sides of the transaction, there is a risk that the corporation will not be treated fairly (because it will pay the executive more money than it ought to, and this will be money that belongs to the shareholders). As we will see below, the courts handle the question of executive compensation in much the same way they handle the more general self-dealing problems we reviewed above: they look essentially to the "fairness" of the transaction, and are influenced by the fact that there has been (or has not been) approval by disinterested directors and/or ratification by shareholders.

B. Forms of compensation: Before we get into the tests by which courts evaluate executive compensation, let us first review briefly the common forms that such compensation may take. Executive compensation arrangements may be grouped into three broad categories: (1) ***current*** payments (salary and annual bonus); (2) stock-based ***incentive*** arrangements (stock options, restricted stock, phantom stock and stock appreciation rights); and (3) pensions and other ***deferred cash*** compensation. We consider each of these groups briefly in turn.

1. Salary and current bonus: Executives almost always receive two types of ***"current"*** cash compensation: a salary that is paid throughout the year, and an annual cash bonus, typically paid at the end of the year. The bonus is usually geared in some way to the corporation's profits. Both the salary and bonus, if they are reasonable in amount, are ***deductible*** by the corporation when paid, in computing the corporation's taxable income.

2. Stock-based incentive plans: Especially in public companies, the corporation (and the outside directors who typically form the compensation committee) worry that senior executives who receive only a salary and an annual bonus will take a short-term view in managing the corporation. To get executives to think more like an "owner," i.e., a shareholder, most publicly held corporations therefore give their executives one or more types of ***long-term incentive*** tied in some way to the performance of the company's ***stock***.

a. Stock options: The most common form of stock-based long-term incentive plan is the ***stock option***. A stock option is the right to buy shares of the company stock at some time in the future, for a price that is typically set today. If the stock price increases (presumably due in part to the executive's good performance) to where the stock is selling for more than the option price, the executive ***"exercises"*** the option by paying the now-bargain price, and then either immediately resells at a profit or holds onto the stock hoping for still more appreciation. If the stock price never rises above the exercise price, the executive never exercises the option, and has therefore not lost anything. There are two sub-types of options which differ sharply in their tax treatment.

i. Non-qualified stock options: A ***"non-qualified"*** stock option (i.e., any option that isn't an "incentive stock option" as described below) does not get any special tax treatment under the Internal Revenue Code. The executive does not receive income when the option is awarded to him; however, when he ***exercises*** the option, he receives immediate income equal to the difference between the exercise price and the present market value, of the stock. This can be burdensome if he wishes to hold onto the stock, since he has to pay taxes without having any cash with which to pay them. (On the other hand, the corporation gets a current deduction for the difference between the exercise price and the present market value, since this is in effect "compensation" and is therefore deductible as an ordinary and reasonable business expense.) See C&E, pp. 701; Clark, pp. 202-03, 210-11.

ii. Incentive stock options: The other kind of stock option is the so-called ***"incentive stock option."*** For an option to be an incentive stock option, it must meet several requirements set forth in the Internal Revenue Code (e.g., the option price cannot be less than the stock's per-share market value at the time the option is granted; the employee may not own more than 10% of the company's voting stock, etc.). Incentive options get special tax treatment: the executive is not taxed on any gain at the time he exercises the option, but only when he ***sells the underlying stock***. If the executive holds the stock bought under the option for a number of years, this deferral of gain has significant value. (On the other hand, the corporation never gets a tax deduction for creating the incentive option. Clark, pp. 21011.)

b. Restricted stock: ***"Restricted stock"*** is a somewhat vague term that refers to stock that is awarded to an employee under a variety of limitations. For instance, an executive might be awarded 100,000 restricted shares, with 10,000 shares "vesting" in each of the next ten years, but only if the executive is still employed on that date. If the executive leaves, his unvested shares would be forfeited. Restricted shares are frequently issued free or at a dramatically reduced price. They are especially useful in a closely-held corporation that expects to go public in the future. C&E, pp. 704-05.

c. Stock Appreciation Rights: A ***Stock Appreciation Right*** (or "SAR") is the right to be paid a future cash bonus based on any ***increase*** in the price of the company's stock. For instance, suppose the company's stock sells for $10 a share on the date the SAR is granted; if the SAR is exercisable after two years, and the stock then sells for $15 a share, the executive would receive a cash payment of $5 ($15 minus $10) for each SAR. Clark, p. 208; C&E, p. 702-03.

d. Phantom stock: ***"Phantom stock"*** is quite similar to an SAR. However, the deferred cash bonus that the executive receives under a phantom stock plan is often equal to the ***total value*** of a share of the company's stock sometime in the future (whereas the SAR only pays him the ***increase*** in that value since the date of grant). Thus a phantom stock plan might entitle Executive to an amount of cash in three years equal to the then market value of 10,000 shares of the company's stock. Executive is not deemed to have received any compensation before the three-year-away settlement date, and he has no voting rights during the interim. He will not receive cash dividends during the interim, but might get some economic benefits from dividends (by having these treated as if he had reinvested them in more phantom stock). Clark, p. 208; C&E, p. 703-04.

3. **Pensions and other long-term deferred compensation:** Corporations also typically have long-term ***deferred*** compensation plans for senior executives. Most common is the ***pension plan*** or retirement plan, by which the executive will receive regular cash payments during retirement. If the retirement plan is qualified under the Internal Revenue Code, the company gets a current deduction for money it puts into the plan, the money inside the plan compounds tax-free, and the executive is not taxed until he actually starts receiving the cash payments following his retirement.

C. **Corporate law problems:** We're now ready to analyze the corporate-law issues which are raised by compensation schemes benefiting senior executives or directors. There are three main issues:

(1) How does one avoid the ***self-dealing*** problem, since the executive is influencing the corporation concerning his own compensation level?

(2) Must there be ***"consideration"*** for the compensation, and if so, what kind? and

(3) May a compensation plan be struck down because it is ***"excessive"***

We consider each of these in turn.

D. **The self-dealing problem:** There is a self-dealing problem whenever the compensation is fixed for either: (1) a director; or (2) an executive who is sufficiently senior that he can influence the corporation's decision about how much he is to be paid.

1. **General rule:** In general, courts treat the self-dealing problems concerning compensation pretty much the same as they treat other kinds of self-dealing. Thus according to most courts, an executive or director compensation scheme is much more likely to be upheld if either: (1) a majority of the ***disinterested directors***

have approved it, following disclosure of all material facts about it; or (2) the ***shareholders*** have approved it, following such disclosure.

a. **Fairness as key:** As with other types of self-dealing transactions, the compensation scheme is much more likely to be upheld if in the court's judgment it is ***"fair"*** to the corporation. In the compensation context, the question, "Is the scheme 'fair' to the corporation?" becomes transformed into the question, "Is the compensation 'excessive'?" Excessive compensation is discussed *infra*, p. 216.

b. **Shift of burden of proof:** As with other types of self-dealing, if the disinterested directors or shareholders have approved the scheme, a much greater showing of unfairness will be needed to strike the plan, and the burden of persuasion shifts from the executive to the person attacking the plan. See, e.g., ALI Prin. Corp. Gov., 5.03(b).

c. **Presence of executive:** If the corporation wants to take advantage of the extra protection from "approval by disinterested directors," the executive should usually not only not take part in the directors' vote on his compensation, but he should not even ***be present*** at the meeting. Clark, p. 194.

2. **Business judgment rule:** The importance of approval by disinterested directors or shareholders is shown by the fact that in many courts, the disinterested directors' decision to approve a scheme will be awarded the protection of the ***business judgment rule***. Under the business judgment rule (see *supra*, p. 182), the directors' decision will be sustained by the court so long as it is rational, informed, and in good faith (despite the fact that the court might have reached a different conclusion about the desirability of the action).

E. **Consideration:** Courts insist that there be ***consideration*** for each element of a compensation plan. In the case of salary and current bonus, the consideration is clear: the executive is working for the company for a particular period, and is being paid for the period.

1. **Deferred compensation:** The requirement of consideration has real bite, however, when the compensation plan includes stock options, retirement benefits, or other consideration that is to be paid far in the future. In brief, the requirement of consideration means that it must be ***very likely*** that an executive will receive the deferred compensation ***only if he remains with the company***. For instance, a grant of stock options to all executives currently at the company, exercisable by them in the future regardless of whether they have remained with the company following the adoption of the option plan, would probably be struck down as lacking in consideration.

2. **Unbargained-for payments for past services:** Another situation in which the requirement of consideration may have some bite is where the corporation makes a large payment upon the ***death*** or ***retirement*** of a senior executive, without there having been a ***prior plan*** or ***contract*** to make such a payment. Although the corporation may defend such a payment on the grounds that the consideration was the "past services" of the executive, the challenger can make the following argument: Where there was no contract or plan to make the payment, the executive could not have been motivated by the prospect of receiving it while he was still working, so the payment amounts to a gift or a waste of corporate assets. Courts have sometimes accepted this argument, and have struck down large payments, made without a pre-existing plan or contract, to senior executives or their estates at retirement or death.

   a. **Ways around:** Observe that there are a number of ways around this problem. Most obviously, the corporation can enact a formal plan of retirement or death payments while the executive is still active; his continued participation until death or retirement is therefore the consideration for the eventual payment. Second, even if there has not been advance planning, the executive can receive payments in retirement (though probably not after death) under a "consulting" contract or a non-competition agreement. Clark, p. 197.

F. **Ban on "excessive" or "unreasonable" compensation:** Even if a compensation scheme has been approved by a majority of the disinterested directors, or ratified by the shareholders, the court may still overturn it if the level of compensation is ***“excessive”*** or ***“unreasonable.”*** As the idea is usually put, “the amount of compensation must bear a ***‘reasonable relationship’*** to the ***value of the services*** performed for the corporation.” Clark, p. 192.

1. **Easier to satisfy than “fairness” rule:** Recall that for most types of self-dealing transactions, the court will strike down transactions it believes to be ***“unfair”*** to the corporation. In the compensation area, the courts are more reluctant to strike down the transaction: it is harder to show that a compensation level is “excessive” than it is to show that a different sort of transaction is “unfair”: “Executive compensation is scrutinized in a less exacting way than are other contracts with interested officers.” *Id.*

   a. **Rationale:** The main reason for this judicial reluctance to strike down compensation as excessive is that courts feel they do not have the appropriate ***standards*** by which to judge the reasonableness of compensation. As one court put it, “[W]hat yardstick is to be employed? Who or what is to supply the measuring-rod? … If comparisons are to made, with whose compensation are they to be made — Executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? … [I]f a ceiling for these bonuses is to be erected, the stockholders who built and are responsible for the present structure must be the architects.” *Heller v. Boylan*, 29 N.Y.S.2d 653 (1941).

2. **Few cases:** Consequently, there are relatively ***few*** cases in which courts have struck down executive compensation plans as being “excessive.” At least where the compensation plan has been approved by disinterested directors or ratified by disinterested shareholders, courts will generally invalidate it only if it is so excessive as to constitute ***“waste.”***

   a. **Standard for “waste”:** The typical definition of “waste” is a very ***restricted*** one. Thus in Delaware, a transaction will not be invalidated as constituting waste unless it is “an exchange that is ***so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”*** *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). In the case of executive compensation, “If … there is ***any substantial consideration received*** by the corporation, and if there is a ***good faith judgment*** [by the board] that in the circumstances the ***transaction is worth while***, there should be no finding of waste, even if the fact finder would conclude ex post that the transaction was ***unreasonably risky***.” *Brehm, supra*.

Example: Consider the facts of *Brehm*, *supra*, p. 175: the board of Disney gives Michael Ovitz a contract which, when terminated early by the company without any breach on the part of Ovitz, gives Ovitz a severance payment of $140 million. Notwithstanding the huge expense and the near-total lack of value actually received by Disney from having Ovitz as its president, the Delaware Supreme Court held as a matter of law that the Disney board did not commit waste in entering into the contract. The board had decided that an expensive compensation package would be required for Ovitz to take the job, and that he would be valuable to the company. Because “the size and structure of executive compensation are inherently matters of judgment,” the board’s decision could be labeled as waste only if the board acted irrationally or in good faith. And, here, the plaintiff had not “alleged with particularity” facts that would prove either irrationality or lack of good faith.

3. **Tax cases about compensation:** The strong reluctance of courts to strike down compensation as excessive under corporate law principles should be contrasted with the result in many ***tax*** cases. Under §162 of the Internal Revenue Code, a corporation may deduct from its gross income its ordinary and necessary business expenses, including a “reasonable allowance for salaries or other compensation for personal services actually rendered.”

Quite frequently, the IRS attacks a particular manager's compensation as "excessive," and the courts have often agreed. In the tax context, the courts have focused on comparable compensation, i.e., how much executives who perform similar functions for similar companies earn. They do not seem troubled by the difficulty of making such comparisons (in contrast to the difficulties in making comparisons that the court in *Heller v. Boylan*, *supra*, p. 217, felt it faced). See generally, Clark, pp. 199-200.

Quiz Yourself on
THE DUTY OF LOYALTY *(EXECUTIVE COMPENSATION)*

50. Mr. Bill is president of Sluggo Storage Systems, Inc. He earns $150,000 per year in that post. The company has no provision for a pension or death benefit for Mr. Bill (or for any other worker). Mr. Bill is killed in a freak accident when he is run over by a steamroller. At the next board meeting, the board unanimously votes to pay Mrs. Bill, Mr. Bill's widow, an annual pension of $75,000.

(a) You represent Spot, a minority shareholder of Sluggo. Spot is not too happy about the pension, but can't think of any grounds upon which to object. What grounds would you recommend?

____

(b) Will the grounds for objection that you recommended in part (a) be successful? _____________________________

Answers

50. (a) Lack of consideration. The issue here is the validity of payments for past services. The general rule from contract law is that such payments are only valid when the basic specifics of the arrangement and the recipient's identity are established *before* the services are rendered (in the form of a contract, a formal bonus plan, or established company practice). Otherwise, such payments are without consideration, since "past consideration" is not consideration at all.

(b) Yes, probably. Mr. Bill was dead before the specifics of the pension were ever worked out, so the pension couldn't have been consideration for his performance of services while alive. Consequently, the court will probably order that the pension not be paid. (Alternatively, the court might say that paying a pension for which there is no consideration is a "waste" of corporate assets, since the corporation receives no benefit from the payment.)

IV. THE CORPORATE OPPORTUNITY DOCTRINE AND RELATED PROBLEMS

A. Introduction to problem: So far in our treatment of the duty of loyalty, we have focused on transactions between the Key Player and the corporation. We turn now to a different type of problem: the Key Player appropriates to himself some ***business opportunity*** or ***property*** that is found to "***belong" to the corporation***. Here, there is rarely an issue as to the "fair" price; instead, if the Key Player has taken something that belongs or ought to belong to the corporation, this is *per se* wrongful and the corporation may recover. There are three sub-problems:

[1] When may a Key Player ***compete*** with the corporation?

[2] When may a Key Player make ***personal use of corporate assets*** (e.g., by using the company plane to fly on a personal vacation)? and

[3] When does a Key Player, by taking advantage of a business opportunity, wrongfully usurp a ***"corporate opportunity"***?

Of these three areas, the third is the most difficult and important. We consider each in turn.

B. Competition with the corporation: A director or senior executive ***may not compete*** with the corporation, where this competition is likely to ***harm*** the corporation.

Example: Able and Baker are both senior vice presidents of Wannabe's, a large department store in downtown Cleveland. While they are on the Wannabe's payroll, they secretly form a new corporation, Newco, and cause Newco to sign a lease on a vacant building across the street from Wannabe's. They intend to set up a competing department store in this building. They then (still while on the payroll) tell some key suppliers that they'll be opening up a competing department store soon, and that they hope to buy from these suppliers. Able and Baker also tell their plans to two of Wannabe's key executives, Charlie and Devon, saying, "We hope you'll come with us in a month or so after we open the new store." This induces Charlie and Devon to work less hard for Wannabe's, since they figure that they, too, will soon be leaving to join the new store.

A court would probably hold that Able and Baker have violated their duty of loyalty to Wannabe's, by effectively competing with Wannabe's while still on the payroll. If so, the court will probably order them to pay money damages to Wannabe's (and might — though probably won't — enjoin them from soliciting any further employees from Wannabe's for some period of time.)

1. **Seek approval or ratification:** But as with other types of self-dealing, conduct that would otherwise be prohibited as disloyal competition may be validated by being ***approved*** by disinterested directors, or being ratified by the shareholders. With either of these methods, the Key Player must first make ***full disclosure*** about the conflict of interest and the competition that he proposes to engage in. See ALI, Prin. Corp. Gov., §5.06(a)(2) and (a)(3). Thus had Able and Baker gone to the directors of Wannabe's in the above example, and announced that they wished to own a competing store, and had the disinterested directors approved of this by a majority vote, there would have been no violation of the duty of loyalty.

2. **Preparation to compete while still in corporation's employment:** Executives and directors seldom engage in active competition while still affiliated with the corporation. Much

more commonly, they ***prepare***, while still on the company's payroll, to engage in later competition. For instance, they may acquire property that will be used in competing, hire employees, negotiate contracts, solicit customers for the soon-to-be-born firm, or otherwise pave the way. There are no hard and fixed rules for this situation, but in general courts tend to hold that these activities constitute disloyalty if they occur while the director or executive is still on the original corporation's payroll. A common remedy is for the court to order a ***return of all salary*** received during this preparation period.

3. **Competition after end of employment:** A quite different situation is presented where the executive or director first ***leaves the corporation*** and only then begins preparing to compete. Assuming that the executive has not signed any "non-compete" agreement, he is ***not barred*** from basic competition with his former employer.

   a. **Trade secrets:** However, he may not compete by the taking of the former employer's ***trade secrets***. Any of the following acts may be deemed to be a wrongful taking of trade secrets: (1) the systematic solicitation of a large number of the former employer's ***customers***; (2) the solicitation of the former employer's ***employees*** to become employees of the new company; and (3) the use of the former employer's secret ***processes*** or other methods of doing business.

   b. **Non-compete:** Additionally, the executive may be barred from competing if he has signed a valid ***non-competition agreement***. However, courts have become increasingly reluctant to enforce broad non-competition agreements, because they do not wish to unduly constrict the executive's ability to earn a living. Therefore, non-competition covenants will be enforced only if they are ***reasonable*** as to ***time***, ***area***, and ***scope***. H&A, p. 630.

      i. **Illustration:** For instance, suppose a dentist agrees with his employer not to compete by practicing dentistry at any place in New York City for a period of two years following the end of his employment; this would almost certainly be found to be too broad to be enforceable. But a promise not to practice oral surgery for six months in the same small town as the employer, by contrast, would probably be upheld.

C. Use of corporate assets: A Key Player may not ***use corporate assets*** if this use either harms the corporation, or gives the Key Player a ***financial benefit*** (including a financial benefit he receives as a stockholder that is not available to other similarly-situated stockholders). See ALI Prin. Corp. Gov., §5.04(a) (reprinted *infra* p. 261). "Corporate assets," for this purpose, consist not only of tangible goods but also intangibles like ***information***.

Example: D, the engineering director of a large aerospace company, learns that the company will be making huge purchases of platinum for a secret project. Only a few people inside the company (and no one outside of it) know that this will occur. D buys platinum futures, and when the news is announced, D sells at a substantial profit. A court might well hold that D has wrongfully used a corporate asset (information about the corporation's plans), in which case the corporation would be entitled to the profits rather than D.

1. Approval or payment: As with other types of self-dealing, ***approval*** by disinterested directors, or ***ratification*** by shareholders (in each case, only ***after full disclosure***) will help ***immunize*** the transaction. Similarly, in the case of use of tangible corporate property, the transaction will not be wrongful if the Key Player pays the ***fair value*** for any benefit he has received. See ALI Prin. Corp. Gov., §5.04(a)(1).

D. The "corporate opportunity" doctrine: Suppose that a senior executive or director of a corporation learns of an attractive business opportunity. Suppose further that this business opportunity is not in an area of commerce in which the corporation presently does business. May the executive or director pursue this opportunity on his own, rather than turning it over to the corporation? The brief, but unhelpful, answer is that the manager may not pursue the opportunity on his own, and must turn it over to the corporation, if the opportunity is one that can be said to ***"belong"*** to the corporation. The difficulty is that the rules for distinguishing between opportunities that "belong" to the corporation and those that do not are confusing, and vary substantially from court to court.

1. **Effect of finding of "corporate opportunity":** If the manager is found to have taken for himself an opportunity that "belongs" to the corporation (i.e., to have usurped a ***"corporate opportunity"***), the rules are very strict: this taking is ***per se wrongful*** to the corporation, and the corporation may recover damages equal to the loss it has suffered, or the profits it would have made had it been given the chance to pursue the opportunity. Often, the court will order any profits made by the manager from the venture to be held in ***constructive trust*** for the corporation, and may order the enterprise itself to be turned over to the corporation. See *infra*, p. 229.

> **Example:** D is the president of Hotel Corp. D knows that Hotel Corp is looking for an appropriately zoned two-acre site in the village of Ames on which it can build a hotel. As D knows, the company's search for such a site so far has been notably unsuccessful. D learns through a friend of a good potential site at a fair price. Instead of allowing Hotel Corp to buy the site, he buys it himself, and resells it for a quick profit to a businessman who puts a car dealership on it. The court is likely to find that by buying the land, D has usurped a corporate opportunity, i.e., an opportunity that properly belonged to Hotel Corp. If the court does so conclude, it will order D's profit on the resale to be turned over to Hotel Corp. (And, in fact, if Hotel Corp is unable to get another site, D may even be liable to pay a larger sum equal to the profits that Hotel Corp could have made had it been offered the site and built a hotel there.)

a. **No issue of fairness of price:** Once the court decides that the manager has taken a corporate opportunity, most courts ***do not***

recognize any separate issue of "fairness." Thus suppose Manager buys Blackacre which, the court finds, he should have offered to the corporation that employs him. The fact that Manager has paid a fair market price for the property (and the fact that a subsequent increase in value is due to an unforeseen increase in values, or to Manager's own unusual efforts) is irrelevant — Manager will still have to account to the corporation for any profits he has made.

2. Delaware multi-factor test: Courts vary in the tests they use for whether an opportunity is a "corporate opportunity." The Delaware courts use a ***multi-factor test***, which has been influential in other courts. Therefore, we'll focus on the Delaware test here.

a. The multi-factor test: Under Delaware law, a business opportunity presented to a corporate officer or director will count as a "corporate opportunity" if it meets the following requirements:

❏ the corporation is "***financially able to exploit***" the opportunity;

❏ the opportunity is "within the corporation's ***line of business"***;

❏ the corporation has an ***"interest or a reasonable expectancy"*** in the opportunity; and

❏ if the director or officer were to embrace the opportunity, he would thereby be placed in a ***conflict*** with his duties to the corporation.

See *Beam v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), quoting the four-factor test originally set out in *Guth v. Loft*, 5 A.2d 503 (Del. 1939).

i. Either "line of business" or "interest or expectancy": The language quoted above from *Beam* sounds as though the opportunity must satisfy *both* the "line of business" and "interest or expectancy" standards. But in practice, the Delaware courts seem to hold that the opportunity must merely satisfy *either* the “line of business” or “interest or expectancy” test, not both. Clark, p. 228.

ii. **Meaning of “line of business”:** Delaware cases often turn on the ***“line of business”*** element. The Delaware courts (and the courts of other states following the general Delaware approach) seem to take a fairly ***broad definition*** of line of business. Even if the activity is not a business that the corporation already engages in, the court is likely to find that the line-of-business test is satisfied if the court feels that the company has some ***special expertise*** that equips it to compete in the new area. Thus a ***“functional relationship”*** between the type of activity the corporation already engages in and the prospective activity may be enough, even though they are in different industries.

Example: Clark (p. 228) suggests that if a company already makes cold medicines, a business that makes contact lens wetting solution would be within its “line of business,” because “the methods of marketing and distributing the products — through drug stores, for example — overlap … enough to permit ***significant economies of scale*** if the businesses were to be combined.”

3. **Other factors (especially for determining “fairness”):** Apart from the four factors applied under the Delaware test (*supra*, p. 221), there are a number of additional factors which courts consider in deciding whether an opportunity is a corporate one. These factors are especially likely to be considered by a court that uses “fairness” as a partial or sole standard:

a. **Capacity in which offer received:** whether the opportunity was offered to the officer or director as an ***individual***, or rather as a corporate manager who would convey the offer to the corporation. The case for regarding the opportunity as corporate is obviously stronger in the latter situation than in the former.

b. **How insider learned of opportunity:** whether or not the officer or director ***learned*** of the opportunity while ***acting in***

his role as the corporation's agent. Thus if President learns of the opportunity while attending a meeting that relates solely to his company's business, the case for finding a corporate opportunity is stronger than where President learns of it while having drinks with a social friend.

c. **Use of corporate resources:** whether the officer or director ***used corporate resources*** to take advantage of the opportunity. An illustration of the use of corporate resources would be where President takes the company jet to scout out the opportunity.

i. **D's use of his own "company time":** Some corporate plaintiffs have claimed that when the defendant (an employee of the corporation) developed the opportunity while on ***"company time"*** (i.e., during working hours), this constituted the "use of corporate resources." However, this by itself is ***unlikely*** to be a very important factor, especially if the time used is not very substantial.

d. **Essential to corporation:** whether the opportunity is ***essential*** to the corporation's well-being. The more important the opportunity is to the corporation's well-being — i.e., the worse financial injury the corporation will suffer if it does not have the opportunity — the more likely the opportunity is to be regarded as corporate.

Example: Suppose Realty Corp, a real estate developer, is trying to complete an assemblage on which to build a single skyscraper. If an executive of Realty snatches away the last lot in the parcel, thus preventing Realty Corp from completing its assemblage, the critical importance to Realty of this last lot makes it very likely that a court will view the lot as an opportunity belonging to Realty.

e. **Distinction between outside director and full-time executive:** whether the person taking the opportunity is an ***outside director*** or a ***full-time executive***. A full-time ***executive*** is commonly understood to owe his ***entire efforts and loyalties*** to the corporation that employs him. An ***outside***

director, by contrast, often has numerous other business interests, some of which will be (and may properly be) more financially important to him than the corporation that he serves only as a director. Therefore, the outside director should be ***more free*** to take an opportunity for himself.

i. **ALI approach:** The ALI's *Principles of Corporate Governance* recognize this distinction:

(1) **Employee:** Under §5.05(b), an opportunity is a corporate one if it comes to a ***full-time employee*** who knows that the opportunity is ***"closely related*** to a business in which the corporation is engaged or expects to engage."

(2) **Outside director:** If the opportunity comes to an ***outside director***, by contrast, the fact that he knows or should know that the opportunity is closely related to the corporation's present or reasonably anticipated activities is ***irrelevant***; the opportunity is not deemed "corporate" unless the director either: (1) learned of the opportunity ***in connection*** with performing his duties for the corporation; (2) learned of it under circumstances where he should reasonably have believed that it was ***really being offered to the corporation*** and not to him personally; or (3) learned of it through the use of ***information or property belonging to the corporation*** (in which situation a full-time employee will also have to treat the opportunity as "corporate.")

See *infra*, p. 227, for a more complete description of the ALI approach to corporate opportunity.

4. **Delaware's "no need for pre-approval by corporation" rule:** Suppose that the Key Player (officer or director) who has the opportunity believes that under the relevant test (e.g., the multi-factor Delaware test described above, *supra*, p. 221), the opportunity is not a corporate one. Must the Key Player ***disclose*** the opportunity to the board of the corporation ***in advance***, and give the latter the chance to argue that this is indeed a corporate

opportunity that the corporation wishes to pursue? At least in Delaware, the answer is a clear ***"no"*** — the Key Player is always *free* to disclose the opportunity and try to get the corporation to say that it's not interested, but the Key Player is ***not required*** to make advance disclosure.

a. Significance: Of course, if the Key Player *doesn't* make advance disclosure, and takes the opportunity for herself, she faces the risk that if the opportunity proves lucrative, the corporation will sue the Key Player and try to unwind the transaction or collect the profits from it. If that happens, then a court will then second-guess the Key Player's judgment that the requirements of the opportunity doctrine were not satisfied. But the Key Player is entitled to take this risk — there is no formal requirement of advance disclosure, at least in Delaware.

> **Example:** Broz is a director of CIS, a publicly-held corporation that offers cellular service in various parts of the country. Broz also owns his own smaller cellular provider, RFBC. Broz learns of the availability of an FCC license called "Michigan-4," entitling the holder to provide cell service in a rural part of Michigan. Broz speaks informally to a couple of CIS directors, and learns that they do not believe CIS would have an interest in the Michigan-4 license. However, Broz does not present the opportunity formally to the entire board of CIS. Instead, Broz causes his own company, FRBC, to buy the license. In so doing, he beats out a competing offer from PriCellular, another cellular provider that is at the time in early discussions about merging with CIS. Shortly after Broz causes FRBC to buy the license, PriCellular and CIS in fact merge. The management of the combined CIS/PriCellular then asserts that the Michigan-4 opportunity was a corporate opportunity of CIS, and that Broz was required to present the opportunity formally to the board of CIS before buying it for himself.
>
> *Held*, for Broz. First, at the time Broz purchased, CIS

was divesting most of its cellular operations, so the company did not have any "expectancy" regarding any new license. Second, it is irrelevant that Broz did not formally offer the opportunity to CIS' board: "It is not the law of Delaware that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped." And the fact that there was some chance that CIS might complete a merger with PriCellular (which as Broz knew wanted the opportunity for itself) is irrelevant, since it was unclear that the merger would ever go through, or that Pri-Cellular might want the opportunity post-merger. *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996).

5. **Who is bound:** Generally, courts seem to apply the corporate opportunity doctrine only to ***directors***, ***full-time employees***, and ***controlling shareholders***. Thus a shareholder who has only a ***non-controlling interest*** (and who is not a director or employee) will generally ***not*** be subjected to the doctrine.

   a. **Lower-level employee:** There are not many corporate-opportunity cases involving ***lower-level employees***. However, such an employee probably has a ***similar duty*** to refrain from usurping a corporate opportunity, under the law of agency (which makes an employee a fiduciary for the employer). See *ALI Principles*, Introductory Note to Part V, sub-par. (b).

      i. **Less likely to be "unfair":** However, when a low-level employee takes a given opportunity for himself, the taking is probably somewhat ***less likely*** to be found to be ***"unfair"*** to the corporation than where the taking is by, say, an officer. So to the extent that the jurisdiction considers "fairness" in deciding whether something is a corporate opportunity, the low-level employee is likely to have an easier time.

6. **Rejection by corporation:** Even if an opportunity is a "corporate opportunity," the Key Player is not necessarily barred from pursuing it himself. If he ***offers the corporation*** the chance

to pursue the opportunity, and the corporation ***rejects the opportunity*** by a majority vote of ***disinterested directors*** or ***disinterested shareholders***, the Key Player may pursue the opportunity himself. S,S,B&W, pp. 809-10. See also ALI Prin. Corp. Gov., §5.05(a)(3)(B) and (C).

a. **Disclosure:** In order for the Key Player to be allowed to raise the defense that the disinterested directors or shareholders have rejected the opportunity on behalf of the corporation, most courts require that the Key Player have made ***full disclosure*** of the nature of the opportunity. Thus if President purports to offer the corporation the chance to pursue the opportunity but ***understates*** the potential benefits, or overstates the cost to the corporation, rejection by the disinterested directors or disinterested shareholders will probably not be a defense. See ALI Prin. Corp. Gov., §5.05(a)(1).

b. **Contemporaneous vs. subsequent rejection:** The safest path is for the Key Player to offer the opportunity to the corporation ***before*** he accepts it himself, and to wait until the disinterested directors or shareholders have rejected it before he acts. But if the Key Player accepts the opportunity himself, and then persuades the disinterested directors or shareholders to ***ratify*** his acceptance (and the corporation's rejection) of the opportunity after the fact, this post-facto ratification may ***still be enough*** to allow the Key Player to escape liability.

   i. **Close scrutiny:** However, courts probably would scrutinize such an after-the-fact ratification ***more closely*** on the theory that it is far less likely to manifest a truly voluntary consent than where the opportunity is offered to the corporation in advance, at a time when the corporation may truly benefit from it.

   ii. **ALI:** In fact, the ALI's Principles are stricter than most courts on this issue; under the ALI approach, there is a flat rule against a director's or senior executive's taking a corporate opportunity unless the opportunity has first been disclosed and offered to the corporation and rejected by it. In other words, under the ALI text, the director or senior executive may not take a corporate opportunity with no disclosure to the corporation, then receive after-the-fact ratification by disinterested directors or shareholders.

7. **Corporation's inability to take advantage of opportunity:** A Key Player who takes a corporate opportunity for himself often tries to defend the subsequent lawsuit by contending that the corporation would have been ***unable*** to take advantage of the opportunity itself, and has therefore suffered no damage. This is a troublesome defense, since if the court allows it, the Key Player will have absolutely no incentive to help the corporation overcome its difficulties — he will simply take the opportunity for himself, and count on being able to make a later showing of corporate inability, a showing which is likely to be quite difficult for outsiders to disprove. Clark, p. 243.

   a. **Types of inability:** There are a number of different types of corporate inability that Key Players have raised when sued for usurping a corporate opportunity: (1) the corporation's ***legal*** inability (e.g., because of antitrust or other regulatory restraints); (2) the ***refusal*** by the person offering the transaction to deal with the corporation; and (3) the corporation's ***financial*** inability to take advantage of the opportunity. Courts are especially reluctant to accept justifications of type (3), since if the opportunity is a good one, there should be a way to overcome financial constraints (e.g., by convincing a bank or other investor to lend money, by taking on a partner, by forming a joint venture, etc.) Clark, p. 243.

   b. **Strict rule:** Courts are in disagreement about whether and when the defense of corporate inability should be accepted. A number of courts take a quite strict view, under which if the Key Player does not make full disclosure to the corporation and offer it the opportunity, he is ***simply not permitted to argue*** that the corporation could not have taken advantage of the opportunity. This "bright line" rule has the advantage of encouraging full disclosure (and honest efforts by the Key Player to help the corporation take advantage of attractive opportunities).

i. ALI: As noted, this is the approach followed by the ALI’s *Principles of Corporate Governance*: If the Key Player does not offer the opportunity to the corporation, and make full disclosure about it, his taking of that opportunity for himself is flat-out wrongful, even if the corporation would have been totally unable to take advantage itself.

Example: D is the president of P, a corporate “club” that owns a golf course. On several occasions, D buys parcels of real estate that immediately adjoin the course. After each purchase, D informs the board of P that she has made the purchases; the board takes no action (it neither affirmatively votes to ratify D’s purchases nor does anything to oppose or undo them.) More than 10 years after the earliest of these purchases, the board finally sues D to have the parcels held in trust for the club, on the theory that D usurped a corporate opportunity. D defends, in part, on the theory that the club never had the funds to have purchased the parcels when they became available.

Held (on appeal), for P: the case is remanded for a rehearing by the trial court, with the ALI principles to be applied. If the trial court concludes (as P alleges) that one or more of the parcels was offered to D in her capacity as club president, the opportunity must be found to be a corporate one. Assuming that D did not make disclosure to the board of the opportunity until after she bought the parcels, and that the board did not thereafter affirmatively ratify her conduct, then D will not be permitted to defend on the grounds that her failure to offer the opportunity was “fair” (e.g., fair because the club was not financially able to exercise the opportunity itself). “The central feature of the ALI test is the strict requirement of full disclosure prior to taking advantage of any corporate opportunity.” (On remand, the trial court concludes that D did indeed usurp a corporate opportunity, but that no recovery is allowable, because of statute-of-limitations and laches problems.) *Northeast Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146 (Me. 1995).

(1) Where Key Player *does* make offer to corporation: On the other hand, if the Key Player *does* offer the opportunity to the corporation and the disinterested directors or shareholders reject it, the corporation's financial, legal or other inability to take advantage of the opportunity *are* to be considered as factors in determining whether they acted "rationally" in rejecting, an additional requirement for the "rejection" defense. See Comment to §5.05(a).

c. Lenient view: Other courts, such as those of Delaware, take a more lenient view toward the defense of corporate inability than does the ALI test. For instance, in *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939), the court treated an opportunity as being a "corporate opportunity" only if the opportunity was one "which the corporation is financially able to undertake." Delaware courts have continued to apply this standard, and to hold that there is no requirement of advance disclosure if the corporation is not in fact financially able to exploit the opportunity.

8. ALI approach: The ALI's *Principles of Corporate Governance* are by far the most comprehensive statutory or statute-like treatment of the problems of the corporate opportunity doctrine. (By contrast, the MBCA doesn't deal specifically with the corporate opportunity doctrine at all, and leaves this area to case law.) Because of the specificity of the ALI treatment, and its growing acceptance by courts, we reproduce the relevant sections:

§5.05 Taking of Corporate Opportunities by Directors or Senior Executives

(a) *General Rule.* A ***director*** or ***senior executive*** may not take advantage of a ***corporate opportunity*** unless:

(1) [He or she] first ***offers*** the corporate opportunity to the corporation and makes ***disclosure*** concerning the conflict of interest and the corporate

opportunity;

(2) The corporate opportunity is ***rejected*** by the corporation; and

(3) Either:

(A) The rejection of the opportunity is ***fair*** to the corporation;

(B) The opportunity is rejected in ***advance***, following such disclosure, by ***disinterested directors*** … in a manner that satisfies the standards of the ***business judgment*** rule; or

(C) The rejection is ***authorized*** in advance or ratified, following such disclosure, by ***disinterested shareholders***, and the rejection is not equivalent to a ***waste*** of corporate assets.

(b) *Definition of a Corporate Opportunity.* For purposes of this Section, a corporate opportunity means:

(1) Any opportunity to engage in a business activity of which a ***director*** or ***senior executive*** becomes aware, either:

(A) ***In connection with the performance*** of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity ***expects it to be offered to the corporation***; or

(B) Through the use of ***corporate information or property***, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe ***would be of interest*** to the corporation; or

(2) Any opportunity to engage in a business activity of which a ***senior executive*** becomes aware and knows is ***closely related*** to a business in which the corporation is engaged or ***expects*** to engage.

• • •

§5.12 Taking of Corporate Opportunities by a Controlling Shareholder

(a) *General Rule.* A ***controlling shareholder*** may not take advantage of a corporate opportunity unless:

(1) The taking of the opportunity is ***fair*** to the corporation; or

(2) The taking of the opportunity is ***authorized in advance or ratified*** by disinterested shareholders, following ***disclosure*** concerning the conflict of interest and the corporate opportunity, and the taking of the opportunity is not equivalent to a ***waste*** of corporate assets.

(b) *Definition of a Corporate Opportunity.* For purposes of this section, a corporate opportunity means any opportunity to engage in a business activity that:

(1) Is ***developed or received by the corporation***, or comes to the controlling shareholder primarily by virtue of its relationship to the corporation; or

(2) Is ***held out*** to shareholders of the corporation by the controlling shareholder, or by the corporation with the consent of the controlling shareholder, as being a type of business activity that will be ***within the scope of the business*** in which the corporation is engaged or expects to engage and will not be within the scope of the controlling shareholder's business.

(c) *Burden of Proof.* A party who ***challenges*** the taking of a corporate opportunity has the ***burden of proof***, except that the ***controlling shareholder*** has the burden of

> proving that the taking of the opportunity is ***fair*** to the corporation if the taking of the opportunity was ***not authorized in advance or ratified by disinterested directors or disinterested shareholders***, following the disclosure required by Subsection (a)(2).

a. **Special features:** Following are a few of the especially noteworthy features of the ALI's treatment of corporate opportunity. (We've touched on some of these above, but for convenience, we discuss the whole ALI approach here in a single place.)

b. **Requirement of advance disclosure:** If the opportunity is a "corporate opportunity," the insider (director, senior executive or "controlling shareholder") ***must offer it to the corporation***, with full disclosure of its nature before he may take it for himself. If he does not make this offer, he will not be permitted to defend a later suit on the grounds that the corporation was unable (for financial or other reasons) to take advantage of the opportunity. As one court has said in adopting the ALI approach, "the central feature of the ALI test is the strict requirement of ***full disclosure*** prior to taking advantage of any corporate opportunity." *Northeast Harbor Golf Club, Inc. v. Harris, supra*, p. 226.

c. **Disinterested directors or shareholders:** The mere fact that the corporation rejects the opportunity does not by itself get the Key Player off the hook. Unless the corporation's rejection is ***authorized*** by a majority of ***disinterested directors***, or a majority of ***disinterested shareholders*** (in either case, following full disclosure), the Key Player will have to show that the corporate rejection and the overall transaction were ***fair to the corporation.***

    i. **Effect of director authorization:** On the other hand, if a majority of disinterested directors ***does*** authorize the rejection, then the transaction is pretty much ***immunized*** against later attack. Only if the disinterested directors have violated the business judgment rule (i.e., they have behaved irrationally; see *supra*, p. 188) may the transaction be attacked.

ii. **Effect of shareholder authorization:** Similarly, if a majority of disinterested ***shareholders*** approves the corporation's rejection of the opportunity after full disclosure, the transaction may be attacked only if their action amounts to "waste."

d. **Senior executive has stricter duty:** As noted, *supra*, p. 226, a ***"senior executive"*** (i.e., a ***full-time*** high-level employee) is held to a somewhat ***stricter standard*** than an outside director. Any opportunity of which the senior executive becomes aware (even if this happens outside of the corporation's business, as at a purely social cocktail party) is "corporate" if the executive "knows [that the activity] is closely related to the business in which the corporation is engaged or expects to engage." §5.05(b)(2). By contrast, if the outside director learns of the opportunity, and does so while not acting either on behalf of the corporation or by use of corporate information, the opportunity is not a "corporate" one. §5.05(b)(1).

e. **Controlling shareholder:** A ***controlling shareholder*** is treated more like a senior executive than like an outside director. The opportunity is a "corporate" one as to the controlling shareholder if either: (1) she learns of it while ***acting on the corporation's behalf***; or (2) or the opportunity is one that is "***held out to the [other] shareholders*** of the corporation" as being "a ***type of business activity*** that will be within the scope of the business in which the corporation is engaged or expects to engage and will not be within the scope of the controlling shareholder's business." (§5.12(b)(2).)

Example: Major is the controlling shareholder of newly-formed Corp, which is to invest in Connecticut real estate. Major also has a separate business that invests in real estate. Major tells his fellow investors, "I'll use my contacts to find good Connecticut real estate investments for Corp." No matter how Major learns of a particular Connecticut real estate investment, it will be a "corporate" opportunity, because Major has indicated to his fellow shareholders that such opportunities will be for Corp rather than for any other businesses in which Major is involved.

9. **Parent-subsidiary problems:** Suppose one corporation owns a controlling (but not 100%) interest in another corporation. In this ***parent-subsidiary*** context, suppose that the parent decides to take a business opportunity for itself rather than for the subsidiary. Does the corporate opportunity doctrine apply? In brief, the answer is probably "yes" — if the opportunity relates much more closely to the subsidiary's present or contemplated business than to the parent's, the parent probably violates its fiduciary obligation to the subsidiary and the subsidiary's minority shareholders by usurping it for itself. This problem is discussed more fully in the treatment of general parent-subsidiary fiduciary questions *infra*, p. 243.

10. **Remedies:** Once the court has determined that a Key Player has usurped what is properly viewed as a corporate opportunity, what ***remedies*** are available to the corporation or its shareholders? The usual remedy is quite draconian: the court may order the imposition of a ***constructive trust***, and may order the Key Player to account for ***all profits*** earned from the opportunity.

    a. **Constructive trust:** If the court imposes a ***constructive trust***, this means that the property is treated ***as if it belonged to the corporation*** that owned the opportunity. The court probably may, but need not, require the corporation to pay the Key Player for the Key Player's direct investment made in creating the opportunity.

    b. **Accounting for profits:** Also, the court will usually order the Key Player to ***account for the profits*** already made from usurpation of the corporate opportunity.

Quiz Yourself on
THE DUTY OF LOYALTY *(THE CORPORATE OPPORTUNITY DOCTRINE)*

51. Mona Lisa Burgers, Inc. — "the burgers with the mysterious sauce" — is an enormous (and rapidly expanding) fast-food chain. Mike Angelo owns 5% of Mona Lisa's outstanding shares, which are publicly traded. Mike is not an officer or director of Mona Lisa, however. Mike knows (as anyone who reads the local business press would know) that Mona Lisa is considering putting a restaurant into the fast-growing suburb of David. Through friends on the David Township planning and zoning board, Mike learns the location of a new freeway that is about to be built through David. He snaps up nearby real estate, knowing that traffic will skyrocket, as will the value of the property. Mike never offers the property to Mona Lisa. Instead, he opens a fast-food restaurant of his own, Sistine Chicken & Ribs.

(a) Mona Lisa sues Mike for usurpation of a corporate opportunity, claiming (quite accurately) that the land would be ideal for a Mona Lisa burger joint. Is Mike likely to be liable? ____________________________

(b) Would Mike be liable if, in addition to the above facts, Mike were an outside (i.e., non-employee) director of Mona Lisa?

____

(c) Would Mike be liable if he was not a director or stockholder at all, but was Mona Lisa's Senior Vice President in charge of sales and marketing? ____________________________

52. Alexis Colby is a director (but not an employee) of the Prime-Time Suds Oil Company. Because Alexis is proud of being exceptionally knowledgeable about the company's affairs, she annually (and at her own expense) takes a tour of some of Prime-Time's properties. While on one such trip to South America, she learns of mineral rights available in Antarctica that seem to have promise for oil. Alexis buys the mineral rights for herself, drills, and finds oil. Has Alexis usurped a corporate opportunity belonging to Prime-Time? ____________________________

53. Peter Pan is a senior employee, and one of seven board members, of the huge, public Darling Pharmaceuticals Company. Darling's area of focus is cancer treatment and prevention. Peter Pan learns about research at Hook University concerning "fairy dust," whose main value is that it makes people fly, but whose secondary value is that people who take it and fly are less likely to get cancer. Peter thinks that fairy dust represents a great commercial opportunity. He calls the chairman and 5% owner of Darling Pharmaceuticals, Wendy Darling, and discusses the opportunity with her at length (making full disclosure of what he thinks the benefits will be). Peter finally says, “So, whaddya think? Shouldn’t Darling Pharmaceuticals be in on a deal like this?” Wendy pauses and says, “Naaaah. You take it.” Peter buys the rights to fairy dust for himself, and it quickly becomes wildly successful. The corporation sues Peter on grounds of usurping a corporate opportunity.

(a) If you represent Peter, what defense will you raise? ______________________________

(b) Will this defense be successful? ______________________________

(c) Suppose fairy dust merely helps people fly, but doesn’t prevent cancer. Assuming that the defense you raised in part (a) is unavailable, has Peter usurped a corporate opportunity? ______________________________

54. Peter Minuit is vice president of the New England Potato Company, which owns vast tracts of land in New York on which it grows potatoes. He learns through friends that Chief Firewater is willing to sell Manhattan Island, prime potato-growing land in New York, for $24. Peter knows that New England Potato is hard-pressed financially, doesn’t have $24 on hand, and probably couldn’t borrow it from a bank. He therefore doesn’t mention the opportunity to New England Potato’s board or president, and instead buys Manhattan with his own funds, with an eye toward putting a big apple orchard there. New England Potato sues Peter for usurpation of a corporate opportunity.

(a) If you represent Peter, what’s the main defense that you should raise. ______________________________

(b) Is this defense likely to be successful? ______________________________

Answers

51. (a) No, because Mike doesn’t owe Mona Lisa a fiduciary duty on these facts. The rule as to corporate opportunities is essentially that “insiders” may not exploit an opportunity that rightly belongs to the corporation. Only directors, employees and controlling shareholders will generally be deemed to be bound by the corporate-opportunity doctrine. [224] The mere fact that Mike owns 5% of the shares won’t be enough to make him a controlling shareholder (and there’s nothing else to indicate he controls the corporation); since he’s also not a director or employee, he’s free to buy the land without regard to whether it might be a valuable opportunity for the corporation.

(b) No, probably. If Mike were a director, he’d be barred from taking anything that was a true corporate opportunity. But the land here probably wouldn’t be deemed to be a corporate opportunity. Where the Key Player is a director (but not an employee), fewer things are deemed to be corporate opportunities. Thus the ALI’s *Principles* say that, vis-a-vis a director, something is a corporate opportunity only if the director either (1) learned of the opportunity in connection with performing his duties for the company; (2) learned of it under circumstances where he should reasonably have believed it was being offered to the corporation, not to him personally; or (3) learned of it through the use of information or property belonging to the corporation. [223] Since the facts suggest that Mike learned of the land (and of the routing of the highway) through means that had nothing to do with Mona Lisa or his director-work for Mona Lisa, the land did not represent a corporate opportunity. Consequently, the fact that the land might have been very useful to the company is irrelevant.

(c) Yes, probably. More things are held to be corporate opportunities when exploited by a full-time employee of the corporation than when exploited by an outside director. Thus the ALI *Principles* say that an opportunity is a corporate one if exploited by an employee who knows that the opportunity is “closely related to a business in which the corporation is engaged or expects to engage.” [223] Since Mona Lisa is currently engaged in the business of putting up fast-food restaurants on vacant land near highways in fast-growing towns (and has already expressed interest in putting a store in David), this was a corporate opportunity vis a vis a full-time employee. Consequently, Mike was required to offer the property to Mona Lisa first, before buying it himself. (The fact that Mike’s area of expertise was sales instead of, say, real-estate acquisitions, won’t make a difference.) The court will probably impose a “constructive trust,” under which Mike will be treated as holding the property for Mona Lisa’s benefit. [229] (Mona Lisa would have to reimburse Mike for his costs before taking control of the property, however.)

52. Yes, probably. As explored in the previous answer, an opportunity is less likely to be found to “belong” to the corporation when exploited by a non-employee director than when exploited by a full-time employee. But even in the director situation, if the director found the opportunity ***in connection with company business***, the opportunity will generally be held to be a corporate one. [223] Since at the time Alexis learned of the Antarctic opportunity she was visiting company properties in connection with her role as director, that opportunity was a corporate one (which she improperly usurped). (If she had been traveling on a vacation that had nothing to do with Prime-Time affairs, she probably would *not* be deemed to have usurped any opportunity, even though the lease would have been of value to Prime-Time — see the answer to question 48(b).)

53. (a) That the corporation, through Wendy its President, rejected the opportunity.

(b) Probably not. Most courts do indeed hold that if the corporation rejects the opportunity after full disclosure, the Key Player may exploit the opportunity himself. The real issue here is whether “the corporation” has in fact rejected the opportunity. It’s true that the President has rejected the opportunity. But most courts would probably hold that rejection does not occur unless either a majority of the disinterested directors, or a majority of the shareholders, have rejected it. [225] Since no disinterested directors other than Wendy have rejected it, true rejection did not occur here.

(c) Probably not. Although the opportunity is drug-related, Darling’s focus — cancer — has nothing to do with a drug that merely helps people fly; Darling’s marketing channels might not even be useful in selling the product. Thus, this probably wouldn’t constitute an opportunity under the line-of-business test, even though “line of business” is typically interpreted very broadly. [222] Under the interest-or-expectancy test, Darling didn’t have any interest or expectancy related to “flying” drugs, nor was such a drug essential to Darling's business. As a result, Peter would probably win with the argument that the opportunity wasn't a "corporate" opportunity at all.

54. **(a) That the company was financially unable to take advantage of the opportunity, and thus hasn't been harmed.**

(b) Unclear. Courts are split about whether and when the corporation's financial inability to take advantage of the opportunity constitutes a defense to a usurpation-of-opportunity claim. Many courts say that unless the defendant made full disclosure of the opportunity to the corporation in advance, he may not later rely on its probable financial inability as a defense. [226] Courts following this view reason that: (1) if the opportunity is attractive enough, the corporation might be able to raise the funds even if it doesn't already have them on hand; and (2) allowing financial inability to be a defense furnishes a bad incentive to corporate insiders, because the defense's availability discourages the insider from seeking a way to help the corporation raise the funds. Since Peter didn't notify anyone associated with New England Potato about the opportunity before taking it for himself, he won't be able to raise the "financial inability" defense later, under this view.

But other courts, including Delaware, don't require advance disclosure as a pre-requisite to a "financial inability" defense. So in those states, Peter's failure to notify anyone at the company before taking the opportunity for himself won't bar his use of the financial-inability defense.

V. THE SALE OF CONTROL

A. Nature of problem: A "controlling block" of shares in a corporation will often be worth more, per share, than a non-controlling block. This fact raises the key question that we discuss in this section: May the controlling shareholder sell his block for a significantly ***higher price*** than that available to non-controlling shareholders who also wish to sell, and keep the excess for himself? In general, the answer is ***"yes,"*** but with some important exceptions.

1. **What is a "controlling block":** First, let's consider what is meant by a "controlling shareholder" or a "controlling block" of stock. A person has effective "control" (and his block is a "controlling block") if he has the ***"power to use the assets of a corporation as [he] chooses."*** S,S,B&W, p. 1138.

   a. **Not necessarily majority:** A person who holds a ***majority*** of the shares of the corporation necessarily has control. But even a ***minority*** interest may be controlling. For instance, the holder of a substantial minority interest (e.g., 30% or more) will usually have effective control if he holds the largest single interest, and the remaining interests are quite fragmented. The existence of a controlling interest is a factual question — a 20% interest might be controlling in one corporation (e.g., a large corporation where no one else owns more than 2%) but not controlling in another (e.g., where someone else holds a majority or a larger minority position).

2. **Why control might be worth a premium:** Why should a control block sell for a ***"premium"***? ("Premium" is the term used to describe the excess that an acquirer pays for the control shares over what he would pay for non-controlling shares.) The answer is that a person with control has the ***"keys to the corporate treasury"*** (S,S,B&W, p. 1139), and may for a variety of reasons attach economic value to those keys. Depending on how this power over the corporate treasury is used, the controlling shareholder may be acting properly or improperly; even a "proper" use of control, however, may have real economic value for an acquirer.

   a. **Change of strategy:** For example, consider Investor, a skilled business person who has been successful at buying troubled corporations and "turning them around" by changing their strategy. If Investor buys a non-controlling interest in Target, he will not be able to influence Target's strategy, and will therefore have to depend for return on his investment on Target's operations and management as these now exist. If, however, he can acquire a controlling interest in Target, he can change the management, sell off assets, pursue new lines of business, or otherwise directly influence Target's future prospects. It would not be foolish for him to pay more, on a per-share basis, for a controlling interest than for a non-controlling interest in Target. (Observe that having Investor acquire a controlling interest in Target might well be advantageous to the non-controlling holders of Target; if Investor makes divestitures, starts new lines of business, etc., and thereby increases the value of the company, these minority holders benefit along with Investor.)

b. **Use for personal gain at expense of others:** On the other hand, one who acquires control may use the corporation for less laudable purposes, and in fact for purposes which leave the non-controlling shareholders ***worse off*** than they were before the acquisition. For instance, Investor may pay a premium to get a controlling interest in Target, then convert some of Target's assets to his ***own personal use***. He might do this in a direct bald-faced manner (e.g., by selling corporate property to himself at a very below-market price) or he might do it in a way that would be harder to attack (e.g., by paying lower dividends on all stock, and using the savings to pay himself an above-market salary as self-appointed president of the company).

c. **Summary:** In any event, whether the acquirer plans to use his control for proper or improper purposes, he would rationally pay more per share for control than for a non-controlling interest.

d. **Seller demands control premium:** Conversely, the existing holder of control will often be unwilling to ***sell*** his stock without getting a control premium, i.e., without getting some compensation that is not given pro rata to other shareholders. After all, he already has control, and is presumably drawing some of the advantages of control (e.g., a cushy salary as president, which he probably will lose if he sells) that the non-controlling shareholders don't have.

3. **Ways of arranging control premium:** Therefore, we have an

existing controlling shareholder and a would-be acquirer, each of whom has an incentive to arrange a transaction in which the controlling shareholder will receive a control premium. Buyers and sellers of control have shown almost limitless ingenuity in arranging ways to pay/receive extra for the control block.

> **Example 1:** Buyer is willing to pay $1 million for the assets of Target, 60% of the shares of which are owned by Dominant. Instead of buying all shares for a total of $1 million (so that Dominant would get $600,000), Buyer buys just Dominant's shares, and pays $700,000 for them. Buyer now controls 60% of the stock. Buyer now causes Target to sell all of the assets to himself for $750,000. Buyer now liquidates the corporation, and receives back $450,000 (60% of $750,000). Buyer has paid the same $1 million net that he was always willing to pay for the assets ($700,000 to Dominant, $750,000 to Target, less $450,000 received back on liquidation of Target). Yet Dominant has received $100,000 more than he would have gotten by a pro rata sale, and the minority shareholders have gotten $100,000 less. See S,S,B&W, p. 998.

> **Example 2:** Same facts as Example 1. However, Buyer merely buys Dominant's shares for $700,000, then continues to operate the business. The minority shareholders have no opportunity to sell, whereas Dominant has cashed out at an attractive price. Buyer may or may not operate the business in a way that benefits the minority shareholders, but clearly Dominant got an opportunity (to sell at a price valuing the whole company at $1 million) that the other holders have not gotten.

4. **General rule allows:** The general rule is that the controlling shareholder ***may sell his control block for a premium, and may keep the premium himself***. Clark, p. 478.

> **Example:** The Ds and their families collectively own 44% of the stock of Gable Industries, Inc. The Ds sell their interests to Flintkote Co. for $15 per share at a time when

Gable stock is selling on the open market for a little more than $7 per share. P, a small shareholder, contends that the minority shareholders should be entitled to share in this control premium (apparently by having the Ds not sell all of their shares, and allowing the minority holders to sell part of theirs to Flintkote).

Held, for the Ds. "[A]bsent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price." The relief sought by P would require that a controlling interest could be transferred only by means of an offer to all stockholders, i.e., a tender offer. Such a radical change should only be done by the legislature, not the courts. *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979).

5. **ALI approach:** The ALI's *Prin. of Corp. Gov.* similarly recognize the general rule that a controlling shareholder may sell his control block for a premium (subject to various exceptions). See §5.16.

6. **Exceptions:** But as *Zetlin, supra,* hints, there are ***exceptions*** to the controlling shareholder's general right to sell his control block for a premium. The three main such exceptions are:

(1) the ***"looting"*** exception;

(2) the ***"sale of vote"*** exception; and

(2) the ***"diversion of collective opportunity"*** exception (which itself has two or three subbranches).

The remainder of our treatment of "sale of control" problems is devoted to these exceptions, which collectively have considerable importance.

B. **The "looting" exception:** Probably the most important exception to the general rule that a controlling shareholder may sell for (and keep) a premium, is the ***"looting"*** exception: "[A] holder of controlling shares may not knowingly, recklessly, or perhaps negligently, sell his shares to one who intends to loot the corporation by unlawful activity." Clark, p. 479.

1. **Investment companies:** The clearest "looting" cases are those in which the corporation's principal or sole assets are stocks, bonds and other ***liquid*** assets. (Such companies are usually called ***"investment companies."***) The "true," i.e., net asset, value of shares in an investment company is usually readily calculated. Therefore, a controlling shareholder who sells his shares to a buyer who is willing to pay more than this net asset value has reason to be suspicious — the high price is almost impossible to understand if the buyer plans to run the company honestly, but very easy to understand if he plans to steal the corporate assets. Clark, p. 479.

2. **Close corporation:** Apart from cases involving investment companies, plaintiffs have only very rarely been able to show that the seller knew or should have known that the buyer intended to loot the company; therefore, there are very few non-investment-company cases in which the plaintiff has prevailed.

3. **Factors considered:** Here are some of the factors that courts have treated as ones that would arouse the suspicions of a reasonably prudent seller and thus trigger a duty to conduct further investigation: (1) the buyer's willingness to pay an ***excessive price*** for the shares; (2) the buyer's excessive interest in the ***liquid*** and ***readily saleable assets*** owned by the corporation; (3) the buyer's insistence on ***immediate possession*** of the liquid assets following the closing, and on immediate transfer of control by resignations of incumbent directors; and (4) the buyer's lack of interest in the details of how the corporation operates. Nutshell, pp. 363-64.

4. **Negligence theory:** Most courts seem to base liability on a theory of ***negligence***: the selling shareholder owes a duty of care to the corporation, and is liable if he breaches that duty by acting negligently (or, worse, recklessly or with malicious intent). Because of this negligence foundation, the courts often award ***damages*** equal to the ***harm*** suffered by the corporation. This

harm will often be greater than the "control premium" (the excess of price paid over a fair market value of the shares), and might conceivably even be greater than the entire purchase price — the seller could find himself not only paying back every dime he received, but then some!

C. **The "sale of vote" exception:** A second major exception to the general rule allowing the controlling stockholder to sell for a premium, is the so-called ***"sale of vote"*** exception.

1. **General ban on sale of office:** To begin with, understand that as a matter of public policy, courts prohibit the bald sale of a corporate office.

   Example: Smith is a director of Corporation, and sits on its nominating committee (which nominates candidates to fill vacancies on the board). Without Smith's vote, the board is equally divided on many important matters of policy. Smith decides to resign, and goes to one of the competing factions. He says that in return for $10,000, he will not only resign, but use his influence with his co-directors on the nominating committee to cause a candidate favored by that faction to be nominated and elected to fill the vacancy.

   Virtually every court would strike down this agreement (and the ensuing nomination and election of a director stemming from it) as violating the public policy against sale of a corporate office. Smith, as a director, owes Corporation a fiduciary obligation, which includes the obligation to nominate the candidate he thinks is best for Corporation, not the one whose election will most benefit Smith personally. Clark, p. 480.

2. **Application to sale of control context:** This rule against the "sale of office" has occasionally been applied to the sale-of-control context, so that the person selling control has to return his control premium to the corporation or the minority shareholders. An illegal sale of office is most likely to be found in two situations: (1) where the control block is much less than a majority of the shares, but the seller happens to have unusual

influence over the composition of the board; or (2) where the sale contract expressly provides for a separate, additional, payment if the seller delivers prompt control of the board.

3. **Small minority:** It may occasionally happen that a shareholder, even though he holds only a ***small minority*** of the shares, happens to have a large influence over a majority of the board of directors. If as part of this shareholder's sale of his shares, he causes this majority to resign and be replaced by directors controlled by the buyer, the court may find that the control premium amounts to a disguised sale of office, and will therefore force the seller to disgorge this control premium.

   a. **Sale of majority of stock:** On the other hand, where what is being sold is a ***majority*** block, courts never strike down a control premium on the "sale of vote" theory — they recognize that the buyer will eventually be able to control the board through the regular stockholder election process, so they see no reason to require him to wait to achieve control.

   b. **"Working control" block:** The sale-of-vote issue is hardest to resolve when what is being sold is something that is, at least arguably, ***"working control."*** Remember that this phrase refers to a block that is less than a majority but still large enough that, as a ***practical matter***, the possessor will ultimately be able to get his nominees elected to a majority of board seats (perhaps because there are no larger minority blocks and the remaining interests are very fragmented). For instance, a 20-40% block will often represent working control of a widely-held publicly traded company. One problem with analyzing such a situation is that there is no way to know in advance whether a substantial minority block will indeed turn out to be controlling in the buyer's hands — the buyer may expect that, say, a 25% block will give him control, yet discover to his chagrin that because of some unforeseen organized opposition, a competing tender offer, or some other reason, he does not get control. In this ambiguous situation, courts are split about whether the seller may legally charge and pocket a premium that depends in part on his delivery of immediate resignations of some or a majority of the directors.

i. ***Essex Universal* case:** In the principal case on this subject, *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962), the two judges who discussed the issue (sitting together on the same panel) disagreed with each other. The block represented 28.3% of the stock, and the seller contracted to deliver to the buyer resignations of a majority of the directors and to cause the buyer's nominees to replace them. One judge believed that the court should presume that the 28.3% block would eventually confer control on the buyer, so that unless the plaintiff could show otherwise, the transaction should be allowed to stand. The other judge believed that (at least as a matter of policy though not as a matter of interpreting New York State law) the seller's agreement to deliver immediate control should be struck down unless it was "entirely plain that a new election would be a mere formality," which he thought was only true for cases involving the sale of a virtual majority, which 28% was obviously not.

4. **Separate payment for sale of control:** A second situation in which the sale of the control block may be found to be an "illegal sale of control" is if the sale contract provides for a ***separate payment*** to be paid only for, and upon, the delivery of directors' resignations and election of the buyers' nominees to the board. However, this is a pitfall that can be easily gotten around by careful drafting: the seller's lawyer must be careful that the contract states a single purchase price for stock and the resignations, rather than separate prices for each.

5. **Subsequent re-election as ratification:** Even where the court might otherwise order the seller to disgorge the control premium because he has in effect "sold his vote," the court may reach a contrary decision if the seller's nominees have been ***re-elected*** at a ***subsequent shareholders' meeting***. In this situation, the fact that the buyer's nominees have been re-elected by shareholder vote shows either that the buyer did have working control, or that the minority shareholders have not been damaged (since they

have ratified the buyer's choices for the board); in either event, there is no reason to confiscate the seller's control premium.

D. Diversion of collective opportunity: The final major category of exceptions to the general rule allowing a control premium has been called the ***"diversion of collective opportunity"*** (Clark, p. 482), a phrase which we use here. This phrase refers to situations in which for one reason or another the control premium should really be found to belong either to the corporation or to all shareholders pro rata. The two main situations in which courts have found such a diversion of collective opportunity are:

[1] where the court decides that the control premium really represents a ***business opportunity*** that the corporation could and should have pursued ***as a corporation***; and

[2] where a buyer ***initially tries*** to buy most or all of the corporation's ***assets*** (or to buy ***stock pro rata*** from all shareholders), and the controlling shareholder instead talks him into buying the controlling shareholder's block at a premium instead.

1. Displaced corporate-level business opportunity: The first of these sub-types of "diverted collective opportunity" is somewhat amorphous: the idea is that the corporation as such has a ***business opportunity*** that it would normally pursue on its own, but for some extraneous reason the value of this opportunity is instead "sold" to the buyer of a control block in return for a control premium. The best-known (and perhaps the only) case clearly illustrating this "displaced company-level opportunity" theory (see Clark, p. 482) is the landmark case of ***Perlman v. Feldmann***, 219 F.2d 173 (2d Cir. 1955). Because of this case's importance, we consider it in some detail:

a. Facts: Feldmann was the president and dominant shareholder of Newport Steel Corp. During the Korean War, the steel industry voluntarily refrained from increasing its prices, even though the war caused demand to skyrocket and shortages to develop. Wilport Co. was a syndicate of steel end-users who wanted to obtain more steel than they had been able to get.

Wilport bought Feldmann's controlling interest in Newport for a price of $20 per share (at a time when the publicly-traded shares of Newport were selling for $12 a share, and its book value per share was $17). Once Wilport gained control, it apparently caused Newport to sell substantial amounts of steel to Wilport's members, though such sales were always made at the same prices Newport charged its other customers. Non-controlling shareholders of Newport sued Feldmann, arguing that the control premium Feldmann had received for his shares was directly due to the premium buyers were willing to pay for steel in a time of shortage, and that this premium was therefore essentially a corporate asset that should belong to all shareholders pro rata.

i. **The Feldmann Plan:** The plaintiffs supported this assertion by pointing out that before the stock sale, Newport had been obtaining some extra benefit from the steel shortage by use of what was known as the "Feldmann Plan." Under the Plan, would-be customers would make interest-free advances in return for firm commitments to them of Newport's future steel production. Newport could then use these interest-free loans to build new plants, improve its existing plants, etc. In other words, use of the Feldmann Plan allowed Newport to in effect raise its prices (by obtaining interest-free loans in addition to the purchase price) without violating the industry's voluntary price guidelines. The plaintiffs apparently claimed (though this is not completely clear from the opinion) that after Wilport took control, it caused Newport to reduce or eliminate Feldmann Plan transactions, at least as to purchases made by Wilport's syndicate members.

b. **Holding:** The Court of Appeals agreed with the plaintiffs that by selling his control block for a premium, Feldmann had ***violated his fiduciary duty to the other share-holders.*** The court made it clear that it was not imposing any general rule that sale of a control block for a premium was a violation of fiduciary obligations. But when there was an opportunity for

corporate-level gain, and instead the controlling shareholder appropriated that gain for himself, there was a breach of such obligations — Newport could have continued to realize its extra profits by maintaining and even expanding the Feldmann Plan; instead, this corporate opportunity was (apparently) transformed into abolition of the Feldmann Plan and dollars into Feldmann's own pocket.

c. **Remedy:** The court took the further unusual step of ordering that any recovery (the amount of the premium) be paid ***solely to the minority stockholders***, not to the corporation. That way, Wilport (now the owner of Feldmann's shares) would not get any benefit from the recovery.

d. **Dissent:** Judge Swan wrote a well-known dissent. He contended that the usual rule (that a controlling shareholder may sell for a premium and keep it) should be applied so long as there was no evidence that the sale of control, or the buyer's subsequent actions, injured the corporation or the minority holders. Here, he found no such evidence — he stressed that Wilport syndicate members paid the same price for Newport steel as any other customer did. (He conveniently ignored the apparent fact that Wilport caused Newport to eliminate the Feldmann Plan, thus effectively lowering prices charged to *all* buyers of Newport steel.)

e. **Significance:** The significance of *Perlman v. Feldmann* is fairly ***narrow***: if the corporation has an ***unusual business opportunity*** that it is ***not completely taking advantage of*** (e.g., the ability to raise prices, to obtain interest-free loans, or otherwise to prosper in a time of great demand for its products), this opportunity ***may not be appropriated by the controlling shareholder*** in the form of a ***premium for the sale of control.***

2. **Seller switches type of deal:** If the buyer proposes to buy the entire company, but the seller instead ***switches*** the nature of the deal by talking the buyer into buying just the seller's control block (at a premium), a court may take away the seller's right to

keep the premium, on the grounds that all shareholders deserve the right to participate.

E. **ALI approach:** The ALI's Prin. of Corp. Gov. don't recognize the above three exceptions as such. Instead, the ALI approach sets out two more general exceptions to the general rule that the control block may be sold for a premium:

❑ The controlling shareholder may not fail to ***make disclosure*** to the other shareholders with whom he deals in connection with the transaction.

> **Example:** *A*, the 52% shareholder of Corp., agrees to sell his block to Acquirer at an above-market price. Simultaneously, as part of his arrangement with Acquirer, *A* recommends to the minority holders that they sell to Acquirer at the market price. *A* doesn't tell the minority holders that he's selling at a higher price. The *ALI Prin. of Corp. Gov.* say that *A* has violated his "duty of fair dealing" to the minority holders. See Illustr. 4 to §5.16.

❑ The controlling shareholder may not sell his control block if "it is apparent from the circumstances that the ***purchaser is likely to violate the duty of fair dealing*** …in such a way as to obtain a significant financial benefit for the purchaser or an associate."

> **Example:** This covers the "looting" situation: if it should be apparent to the controlling holder that the purchaser will sell corporate assets to himself at a below-market price, or sell property to the corporation at an above-market price, the controlling shareholder can't carry out the transaction (even at a market price).

F. **Remedies:** As we've said above, in a normal situation the controlling shareholder may sell for, and keep, the control premium. But in those special situations where the general rule does not apply (sale to looter, sale of office, diversion of collective opportunity), what exactly is the ***remedy*** that the plaintiff who succeeds on the merits will receive? The two basic possibilities are: (1) return of the premium to the corporation; and (2) payment of some portion of the premium directly to the non-controlling shareholders.

1. **Recovery by corporation:** For these three theories of recovery — sale to looter, sale of office and diversion of collective opportunity — the most logical form of recovery is ***by the corporation***. At least arguably, it is the corporation's assets that have been sold to produce the control premium, so it is the corporation that should get the premium back. This is indeed how some cases have been decided.

2. **Benefits purchaser:** But there is a big problem with having the control premium returned to the corporation: this remedy gives the ***purchaser*** — the very person who agreed to pay the control premium — an unanticipated and probably undeserved windfall. For instance, if Dominant owns 50% of Target, and sells that stake to Buyer for a $10 per share premium, if the premium is ordered returned to Target then half of it will effectively end up in Buyer's pocket (since he now owns 50% of Target's shares). Therefore, the court may decide to order the seller to repay ***directly to the minority shareholders*** their pro rata part of the control premium.

   a. ***Perlman v. Feldmann:*** This is exactly what happened on remand in *Perlman v. Feldmann*, *supra*, p. 238. The district court concluded that the premium had been $5.33 a share, or $2,126,280. The non-controlling minority shareholders owned 63% of the stock. Therefore, the court ordered that the selling controlling holder pay them $1,339,769 (63% of $2,126,280). See *Perlman v. Feldmann*, 154 F.Supp. 436 (D. Conn. 1957). This method allowed Feldmann to keep his pro rata share of the control premium, and prevented the buyers from getting back any of the benefit from the control premium they had paid.

Quiz Yourself on
THE DUTY OF LOYALTY *(THE SALE OF CONTROL)*

55. Abner Doubleday is a 55% shareholder of the NASDAQ-listed Splendid Splinter Baseball Bat Company, Inc. The fair market value of Splendid Splinter's stock on NASDAQ is $20. Doubleday decides he wants to give up the bat business and go into something really lucrative — forging sports memorabilia. Scuff Spitballer, a reputable businessman, offers to buy Doubleday's shares for $30 each, if he's willing to sell all of them. Doubleday accepts the offer. Splendid Splinter's minority shareholders sue Doubleday on behalf of Splendid Splinter, seeking the $10 premium he received for his shares over fair market value. Who wins?

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56. Ali Baba Art Galleries, Inc., buys and sells fabulously expensive works of art. Ali Baba, controlling shareholder of the galleries, sells his shares to Scheherezade, at a price $20 a share above market value. Scheherezade immediately begins to sell to herself the Galleries's inventory of art works at grossly understated prices. By the time minority shareholders wake up and sue Scheherezade, she has secreted the works (apparently in the vaults of an unidentified Swiss bank), and is thus effectively judgment-proof.

(a) You represent one of the minority holders. On what theory might you sue Ali Baba for the difference between the true value of the artworks sold by Scheherezade to herself and the price she paid?

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(b) State the factors (not necessarily ones presented explicitly in the above statement of facts) that, if proved at trial, would support your theory of recovery. ______________________________

57. The Sleeping Beauty Sewing Machine Company has seven directors. Its shares are publicly traded, with a price hovering around $10 a share. Evil Stepmother decides she wants to acquire control of the company. Evil Stepmother approaches five of the directors — Grumpy, Dopey, Sleepy, Bashful, and Doc — and asks them to sign a document in which they agree that they will (1) immediately resign and (2) as a final act on the board, vote for Evil's nominees as their successors as directors. The document also states that Evil will pay each director $20 a share for his shares. The five directors together own about 7% of the company's stock. (The President owns about 25% of the stock, and the rest is held by the public at large.) The directors sign the agreement, then resign and vote as they've agreed to do.

(a) What is the best theory under which a minority holder in the company could sue the 5 resigning directors? ____________________________

(b) Will that theory succeed? ____________________________

Answers

55. Doubleday. The issue here is whether a controlling shareholder can sell his control at a premium — that is, a price above the fair market value of the shares. The *general* rule is that he may, in fact, sell his shares for whatever price he wants. [234] There are exceptions to this doctrine, but none of the exceptions applies here. (For instance, Doubleday has no reason to believe that the buyer will loot or otherwise harm the corporation, Doubleday hasn't explicitly agreed to transfer control of the board as a condition of the deal, and there's no reason to believe that the premium is a diversion of a "collective opportunity.") So Doubleday is within his rights in collecting something extra for his controlling stake, even though he's getting a benefit not available to other shareholders.

56. (a) That Ali Baba knew or should have known that Scheherezade was likely to "loot" the company.

Part of a controlling shareholder's fiduciary duty to his corporation is that he cannot sell control to anyone whom he knows or should know will harm the company (e.g., by looting the company's treasury, committing fraud on the corporation after acquiring control, or implementing business policies that would harm the corporation or its shareholders). [235]

(b) Any facts that ought to have put Ali on notice of Scheherezade's intent-to-loot would be helpful.

Look for pre-transaction facts known to Ali, such as Scheherezade's exaggerated interest in the corporation's liquid assets; any demand by her that control be transferred to her immediately following the closing; any sign that she had only a negligible interest in the corporation's operations; or evidence that as Ali knew, Scheherezade had engaged in similar self-dealing with corporations she'd bought in the past. [235] (Her mere payment of a substantial premium for control, by contrast, would be only a *weak* indication that she might intend to loot the corporation.)

57. **(a) That the document constituted an illegal "sale of office."** A director or group of directors, like any other shareholder, can normally sell for a "control premium." However, a director cannot baldly sell "his office," i.e., his directorship. [236]

(b) Yes, probably. Since the 7% stake bought by Evil would not normally have given her control of the board, and since the purchase agreement here was expressly contingent on the sellers' resignations and votes for Evil's board nominees, it's hard to imagine a more blatant sale of a directorship. So the court will probably order the selling directors to disgorge the control premium either to the corporation or (preferably) directly to the shareholders other than Evil. (If the 5 selling directors owned, and were selling, a *majority* of the shares, then probably no sale-of-office would be found; that's because Evil would have been able to get control of the board eventually, even without the resignations and succession votes by the sellers. The same would probably be true if the selling directors were selling Evil a "working majority." [236])

VI. OTHER DUTIES OF CONTROLLING SHAREHOLDERS

A. Introduction: So far in this chapter, we have looked at various contexts in which controlling shareholders, like directors and executives, have a duty of loyalty to the corporation. We now focus on a collection of miscellaneous contexts in which controlling shareholders, in particular, may have a special duty of loyalty to their fellow non-controlling shareholders. Of these special contexts, the most important is that involving a parent-subsidiary relationship — a parent that does not own all the stock of the subsidiary is generally held to have a fiduciary obligation to the subsidiary's minority shareholders. This topic is discussed beginning *infra*, p. 243.

B. Possible general fiduciary duty: Does a controlling shareholder have any kind of ***general fiduciary duty*** to his fellow non-controlling shareholders?

1. **Not covered by statute:** Few if any states impose such a general fiduciary duty on the controlling shareholder by ***statute***. For instance, the MBCA is completely silent about the general fiduciary obligations (if any) owed by controlling shareholders. (Of course, if the controlling shareholder is also a director or executive, there are likely to be statutory duty-of-loyalty obligations explicitly imposed on him, such as MBCA §8.31's rules on self-dealing transactions involving directors. But the point I am making here is that few if any statutes impose fiduciary obligations on a shareholder *qua* shareholder.) Therefore, any fiduciary obligations must be imposed as a matter of ***case law***.

2. **Close corporation situation:** In the case of a ***close corporation***, some courts have expressly concluded that the controlling shareholder has a significant fiduciary obligation to his fellow shareholders. See, e.g., the landmark case of *Donahue v. Rodd Electrotype Co, supra*, p. 161. Thus Massachusetts (the state where *Donahue* was decided) as a matter of case law prevents a controlling shareholder in a close corporation from putting his own interests ahead of those of his fellow shareholders. For instance, the controlling shareholder may not cause the corporation to redeem some of his own shares at an attractive price, without also causing the corporation to offer a similar redemption arrangement to the minority shareholders. *Donahue*, *supra*.

3. **Public corporations:** Where the corporation is ***publicly held***, the courts have been less quick to impose on the controlling shareholder a fiduciary obligation with any real bite. The fact that a controlling shareholder is generally allowed to sell his controlling interest at a premium (*supra*, p. 234) is one illustration of this lack of any generally-recognized fiduciary obligation to one's non-controlling co-shareholders.

a. **Possible duty of complete disclosure:** However, even in the public-company context, when a controlling shareholder or group deals with the non-controlling shareholders some courts say the controller owes the non-controllers a ***duty of disclosure*** (not a duty to behave with substantive fairness) with respect to the transaction, as a matter of state common law.

Example: Controlling shareholders in ABC give notice of the proposed buyback of a minority block of stock, without telling the minority holders that due to secret developments the minority holders would benefit by exercising certain conversion rights. A court might well hold that this failure to give complete disclosure violated the majority's common-law obligation to the minority. See, e.g., *Zahn v. Tansamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), so holding.

C. **Parent/subsidiary relations:** Most cases involving the duties of a controlling shareholder to the non-controlling holders arise in the context of the relationship between a parent and its ***not-wholly-owned subsidiary***. In general, these parent/subsidiary cases are analyzed the same way as any other case involving the duties of a controlling shareholder to the non-controlling holders. Thus some courts say that the parent has a fiduciary obligation to the other shareholders in the subsidiary, but it is not clear how much bite this obligation has. We must look at different contexts (e.g., merger, dividends, parent-subsidiary contracts, etc.) to get a meaningful view of what the parent's obligations are, since these vary depending on the context.

1. **Merger:** It will often be the case that the parent wants to turn the subsidiary into a ***wholly-owned*** subsidiary, by ***buying out*** the minority shareholders and then merging the subsidiary into the parent. In these transactions, the general rule is that the merger must be at a ***fair price***. The main legal issues are: What price is fair? and How should the determination of fairness be made? This topic is discussed extensively beginning *infra*, p. 411; see especially the treatment of *Weinberger v. UOP*, *infra*, p. 425.

2. **Dividends:** The parent, by virtue of its controlling interest in the subsidiary, will be able to control or at least influence the subsidiary's ***dividend policy***. The minority holders may not like this dividend policy: they may feel that the dividend is too high (and the cash should instead be reinvested in the subsidiary's business rather than being paid out pro rata to the parent and to the minority holders); or, they may feel that the dividend is too low (and should be paid out rather than re-invested in the subsidiary's business). The minority holders can plausibly argue that when the parent sets the subsidiary's dividend policy, the parent is engaged in a self-dealing transaction (defined *supra*, p. 198), and that the policy should therefore be closely scrutinized by the court.

   a. **Unsuccessful argument:** However, the minority holders in this parent/subsidiary situation have generally been ***unsuccessful*** at getting the courts to apply the self-dealing rules to dividend transactions. Courts generally are swayed by the fact that the dividends are paid ***pro rata*** to all shareholders, so the parent isn't getting any more money ***per share*** than are the minority holders. Courts that take this view ignore the fact that different shareholders have different preferences, and the fact that a given dividend policy that is good for the parent may be bad for other shareholders. In any event, the general rule seems to be: even though the parent may be controlling the subsidiary's dividend policy, so long as that policy satisfies the ***business judgment rule*** (i.e., it isset in good faith after reasonable investigation, and is not completely irrational;[1] see *supra*, p. 182), it will be ***upheld*** by the court.

      Example: Sinclair Oil ("Sinclair") owns 97% of the stock of Sinclair Venezuelan Co. ("Sinven"). Sinclair controls the board of directors of Sinven. Sinclair causes Sinven to pay out extremely high dividends (in fact, dividends in excess of Sinven's earnings) during a 7-year period. The Ps (who are among the 3% minority stockholders in Sinven) sue Sinclair, arguing that this dividend policy violates Sinclair's fiduciary duty to Sinven.

Held, for D (at least on this point). The dividends were paid in proportion to stockholdings, so that Ps got their aliquot share (3%) of all dividends paid. Therefore, the setting of the dividend policy was not self-dealing by Sinclair. Instead, the policy must be judged by the business judgment rule. Since the Ps cannot show that the dividends resulted from "improper motives and amounted to waste," the business judgment rule is satisfied and the dividend policy must be upheld. (Other aspects of the case are discussed *infra*, p. 244). *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

3. **Self-dealing between parent and subsidiary:** As *Sinclair* indicates, the fact that Parent has set Subsidiary's dividend policy does not constitute self-dealing. But other types of transactions between Parent and Subsidiary may well be found to be self-dealing. If so, these transactions are judged by the same rules applied to self-dealing transactions outside of the parent/subsidiary context. (See *supra*, p. 200, for an explanation of these rules.) In general, the minority holders in Subsidiary can therefore get a self-dealing transaction struck down if they can show that it was ***not fair*** to Subsidiary and that it was not approved by either ***disinterested*** directors or disinterested shareholders.

a. **Dominated board:** In the common situation where Parent dominates the entire board of Subsidiary, this means that unless the ***minority shareholders*** have been given a chance to ***ratify*** the self-dealing transaction, they can have the court strike down the transaction if it is not fair to them. In fact, once the minority holders of Subsidiary show that there has been self-dealing by Parent with respect to Subsidiary, the ***burden of proof shifts*** to Parent: Parent must now ***show affirmatively*** that the transaction was ***fair*** to Subsidiary.

Example: Go back to the facts of *Sinclair*, *supra*. Sinclair and Sinven make a contract in which Sinven agrees to sell all of its crude oil and refined products to Sinclair at specified prices, payment to be made on receipt. The contract includes minimum and maximum quantities. Sinclair breaches the contract in several respects (e.g., it does not pay on receipt, and it does not order the contractually-specified minimums). The Ps (minority shareholders in Sinven) claim that the contract constituted self-dealing, and that it should be struck down unless Sinclair shows that the contract was fair.

Held, for the Ps. "Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." Here, the contract meant that Sinclair was taking Sinven's oil for itself, rather than allowing the oil to be sold on the open market. Therefore, the contract was self-dealing. Such a self-dealing contract will only be upheld if the parent satisfies the "intrinsic fairness" standard. Here, Sinclair did not bear the burden of showing why Sinven's failure to enforce the contract against Sinclair was "intrinsically fair" to the minority shareholders of Sinven. Therefore, Sinclair is liable to the minority holders for their share of the damages that Sinven could have obtained for breach. *Sinclair Oil Corp. v. Levien*, *supra*, p. 244.

b. Other kinds of contracts: *Sinclair* was a very clear example of self-dealing (even though the level of unfairness to the minority holders was apparently not great): Parent was buying all of Subsidiary's output. But courts have also found self-dealing — and struck it down on grounds of unfairness — where the presence of Parent on both sides of the transaction with Subsidiary was much more subtle. For instance, the court may hold that Parent's provision of legal, accounting, financial or other general ***corporate services*** to Subsidiary amounts to self-dealing, and must be struck down if unfair.

4. Acquisitions and other corporate opportunities: Recall that the doctrine of ***"corporate opportunity"*** prevents a Key Player from usurping for himself an opportunity that is found properly to “belong” to the corporation. This corporate opportunity doctrine may apply in the parent/subsidiary context: If Parent takes for itself an opportunity (e.g., an ***acquisition***) that the court finds really belongs to Subsidiary, the minority holders of Subsidiary will be able to reclaim that opportunity for Subsidiary, or at least recover damages.

a. Standard: In general, courts have applied the same corporate opportunity doctrine in the parent/subsidiary context as they do in the ordinary non-subsidiary situation. See Clark, p. 256. For instance, if the court would apply a multi-factor test like Delaware’s (p. 221) to a transaction in which President takes for himself a business opportunity that might have been taken by Corporation, the court would presumably also apply this multi-factor test to determine whether an opportunity taken by Parent belongs to Subsidiary.

5. Disinterested directors: Both for self-dealing transactions and for corporate opportunities, Parent may avoid claims of unfairness by Subsidiary’s minority shareholders if Parent somehow (perhaps temporarily) “undoes” its domination of Subsidiary. For instance, if Subsidiary has some truly ***disinterested directors*** (e.g., directors elected by the minority shareholders), Parent could let these disinterested directors ***negotiate on behalf of Subsidiary.*** This would help immunize any contract between Parent and Subsidiary against a claim of self-dealing, and would permit Subsidiary to pursue any business opportunity on its own that was also being pursued by Parent.

a. Mergers: In the case of a proposed ***merger*** of Subsidiary into Parent (and consequent forced buyout of the minority shareholders of Subsidiary), having Subsidiary represented by such an independent committee of directors is now the normal way of proceeding. See *infra*, p. 426.

Exam Tips *on*

THE DUTY OF LOYALTY

The duty of loyalty is the single most frequently-tested subject on exams. Duty of loyalty issues often appear in the same fact patterns as duty of care issues. Watch particularly for ***self-dealing transactions*** (transactions in which a director has a ***financial interest***) and situations in which a director or senior exec. takes personal advantage of an ***opportunity*** which might ***belong to the corporation.***

☛ ***Self-dealing transactions*** are usually easy to spot. Look for situations in which the corp. has ***conducted business*** with a director or senior exec. ("Key Player"), or with a member of a Key Player's family.

Once you spot a self-dealing transaction, remember that you have to do a ***multi-step analysis*** to determine whether it's a breach of the duty of loyalty:

Step 1: Did the Key Player ***disclose*** the conflict and the nature of the transaction ***in advance*** to either senior management or the entire board (whichever would normally be expected to make the decision for the corp. on whether to do the transaction)? If "yes," go to Step 2. If "no," got to Step 3.

Step 2: [For advance disclosure situations]: Did a majority of the ***"disinterested directors"*** (or a ***"disinterested superior"*** if the Key Player is not a director) ***approve*** the transaction? If "yes," there was ***no breach*** of the duty of loyalty. If "no," go to Step 3.

Step 3: [For situations where there was no advance-disclosure-plus-approval]: Did the Key Player ***disclose*** the conflict and nature of the transaction ***after*** it was entered into (either before suit or within a reasonable time after suit was filed), to either senior management or the board (as appropriate — see Step 1)? If "yes," go to Step 4. If "no," go to Step 5.

Step 4: [For after-the-fact disclosure situations]: Did a majority of the ***"disinterested directors"*** (or a "disinterested superior" if the Key Player is not a director) ***ratify*** the transaction? If "yes," there was no breach of the duty of loyalty. If "no," go to Step 5.

Step 5: [For situations where the board never gave proper approval or ratification]: Did a majority of ***disinterested shareholders***, following disclosure of the conflict and the transaction, either ***approve it*** in advance or ***ratify it*** afterwards? If “yes,” go to Step 6. If “no,” go to Step 7.

Step 6: [For situations where the disinterested s/h’s approved]: Was the transaction a ***“waste”*** of corporate assets, viewed as of the time of s/h approval or ratification? If “no,” there was ***no breach*** of duty of loyalty. If “yes,” it ***is a breach*** of the duty of loyalty.

Step 7: [For sits. where there is neither board nor s/h approval or ratif.]: Was the transaction ***“fair”*** to the corp. when entered into? If “yes,” there is no breach of duty of loyalty.

If “no,” there is a ***breach*** of loyalty.

Example: Pres, the president of A Corp., negotiates an agreement for A Corp. to buy all of Y Corp’s outstanding shares. Only one of A’s 6 other directors is told by Pres. that Pres’s immediate family holds all of Y Corp’s shares. The board approves the transaction. Y Corp. proves to have little value. A minority s/h brings a derivative action against Pres. for damages from the purchase. You should say that since there was never disclosure of the conflict to all the independent directors [Steps 1 and 3 above], and since there was no shareholder approval [Step 5], the court will strike down the transaction unless it believes that the transaction was “fair” to the corporation [Step 7].

Other examples of self-dealing: (1) Pres. negotiates to have all of Corp’s properties cleaned by X Co., and doesn’t disclose that he has a large ownership interest in X Co. (2) B, a director of Corp., conveys equipment worth $50K to Corp. in return for $100K of stock, without disclosing that the equipment is only worth $50K (and while knowing that most directors think it’s worth $100K).

☞ Always remember that ***pre-approval*** (after disclosure) by a majority of the ***disinterested directors*** or a majority of ***disinterested shareholders*** will ***immunize*** the transaction, and a court will not even consider whether the transaction is “fair.” (See Steps 2 and 5.)

☞ Also, post-transaction ***disinterested-shareholder ratification*** of the transaction, made after disclosure and before suit, will always ***immunize*** the transaction (Step 5), and post-transaction disinterested-***director*** ratification will usually immunize it (Steps 3-4).

☞ Remember that if the facts suggest to you that the transaction was ***"fair"*** (i.e., not disadvantageous) to the corp., ***viewed as of the time it was made***, it won't be set aside or serve as the basis for damages, even if there was no disclosure, no independent-director approval and no shareholder approval. That is, fairness puts a ***complete end*** to the inquiry.

☛ Whenever a fact pattern indicates that a Key Player has taken personal advantage of an opportunity, consider whether the doctrine of ***corporate opportunity*** applies. Remember that this doctrine prohibits a Key Player from taking advantage of an opportunity which belongs to the corp., unless he first ***discloses*** the offer to the other directors or to senior management.

☞ Here are some factors which strengthen the inference that an opportunity is a corporate one:

❏ The Key Player ***learned*** of the opportunity while acting in his role as the ***corp's agent*** rather than as an individual;

❏ The opportunity is ***closely related*** to the corp's ***existing or prospective activities***;

❏ The opportunity is ***essential*** to the corp's ***well-being***; or

❏ The corp. had (and the Key Player knew that the corp. had) a ***reasonable expectation*** that the opportunity would be regarded as a corporate one.

Example: At a board meeting of A Corp., B, a director of the corp., learns that the corp. is planning on expanding, and that it's examining 3 parcels adjacent to one of its existing plants. B pays $3,000 for an option to buy one of those parcels for $120,000, and does not tell his fellow directors before doing this. B has probably usurped a corp. opportunity, since he learned of the parcel's availability from his work for the corp., the parcel is closely related to the corp's prospective activities (expansion), and the corp. reasonably expected that any parcels considered during the board meeting would be viewed as corporate opportunities. Therefore, B can probably be required to turn over the option to the corp.

- ☞ It generally takes less of a conflict for the corp. opportunity doctr. to apply when the Key Player is a ***full-time employee*** than where she is an ***outside director***.

- ☞ If the corp. opport. doctr. otherwise seems to apply, check whether the fact pattern contains signs that the corp. ***wouldn't have been able to take advantage*** of the opportunity even had it known of the opportunity. Say that courts are ***split*** about whether corporate inability (e.g., ***lack of financial resources***) can be a defense.

☛ Be alert for duty-of-loyalty issues where the fact pattern involves ***executive compensation***. Make sure that the corp. is receiving some benefit as a result of the compensation scheme — if it's not, it's likely to be invalid as a ***"waste"*** of corporate assets.

- ☞ If a compensation arrangement is ***approved in advance*** by ***disinterested directors or disinterested s/h's***, this pretty much ***immunizes*** it from s/h attack, even if a court might otherwise believe the compensation is ***"excessive."*** (Courts are split as to whether this is true even where the person receiving the compensation is a ***senior executive*** who has ***participated in the process*** by which the compensation was set.)

- ☞ ***Stock options*** are ordinarily acceptable, provided they do not result in clearly excessive compensation.

- ☞ ***Retirement benefits*** may pose a problem, especially if they are awarded at the ***moment of retirement,*** without being part of a general or pre-existing plan. Here, a s/h could claim that this is waste (or without consideration), because the corp. isn't getting anything in return. (*Example:* At the moment when Bill, a senior manager at A Corp., says he's retiring, Prexy [pres. of A Corp.] makes a written promise to pay Bill a $4,000/mo. pension for life. A Corp. does not have any general pension plan. A s/h might successfully attack this promise as being waste and without consideration, in which case the court may order the promise not to be enforced.)

☛ Sometimes you'll have a problem of ***interlocking directors*** (X is a director of two corps who do business with each other). Here, say that the duty-of-loyalty problems are typically ***not as severe*** as where a director deals for himself: unless the director's ***own financial interest is substantially at stake***, the fact that he sits on both boards won't create a conflict when the two corps do a transaction together (as long as there's disclosure of the fact that the director sits on both boards).

Example: X is a director of both A Corp. and B Corp., and each corp. knows this. At a B Corp. meeting, X votes to have B Corp. buy certain property from A Corp. Unless X's financial stake in A Corp. (and the size of the transaction) are enough to give X a significant financial incentive to have B Corp buy the property, X's voting for the transaction is ***not*** a breach of his duty of loyalty to B.

☛ Keep in mind that a ***controlling s/h*** may (it's not clear) have an obligation to behave in a ***fiduciary manner*** towards minority holders. This principle is most likely to be applied if the majority tries to ***"freeze out"*** the minority. Be especially alert to freeze-out and other mistreatment-of-minority problems if the corp. is a ***closely-held*** one.

Example: A, B, C, and D each own 25% of Corp. Corp. has always paid generous dividends to each s/h, since Corp's own operations don't need much capital. A, B, and C learn that D is desperately in need of cash, and is counting on continuation of the dividend stream. The 3 vote to suspend dividends for the sole reason of pressuring D, so that they can induce him to sell his stock back to Corp. cheaply. This is probably a violation of the duty of loyalty, since A, B and C have served their own interests rather than the interests of all holders.

☛ Even if you conclude that there's been a breach of the duty of loyalty, be sure to check that the corp. has suffered an ***actual loss*** — if there's no actual loss, then there can't be any recovery.

[1] Courts seem to ignore the third requirement for the business judgment rule, that the decision-maker not be ***"interested"*** in the decision. Thus even though it's the parent or its employees and directors, not independent directors of the subsidiary, who set the dividend policy, the policy will get the benefit of the business judgment rule if it's set in good faith, after reasonable investigation, and in a not-completely-irrational way.

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PART IV

Corporate Fiduciary Duties

CHAPTER 11

Corporate Fiduciary Duties—An Introduction

At the heart of corporate law lie duties of trust and confidence—fiduciary duties—owed by those who control and operate the corporation's governance machinery to the body of constituents known as the "corporation." Directors, officers, and controlling shareholders are obligated to act in the corporation's best interests, which traditionally has meant primarily for the benefit of shareholders—the owners of the corporation's residual financial rights.

State courts, not legislatures, have been the primary shapers of corporate fiduciary duties. Judicial rules balance management flexibility and accountability, producing often vague and shifting standards. The American Law Institute has contributed the Principles of Corporate Governance (see §1.2.4) to articulate and provide guidance on corporate fiduciary duties and the standards of judicial review they entail. Fiduciary duties fuel the ongoing debate over the function and responsibility of the corporation in society.

This chapter introduces the theory and nature of corporate fiduciary duties (§11.1), gives an overview of the duties of care and loyalty (§11.2), and describes the reality of fiduciary duties in modern corporations (§11.3), particularly as they relate to independent directors (§11.4). The chapter also offers an overview of recent federal legislation—the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010—that introduce a variety of corporate governance reforms in public corporations and thus federalize some corporate fiduciary duties (§11.5).

The other chapters in this part describe corporate fiduciary duties in specific contexts, as well as the procedures for their enforcement:

- duty of care of directors in making decisions and monitoring corporate affairs, as well as the operation of the business judgment rule and statutory exculpation provisions (Chapter 12)
- duty of loyalty of corporate officials when they enter into self-dealing transactions with the corporation and judicial review for fairness (Chapter 13)
- judicial review of executive compensation under corporate fiduciary law and federal restrictions and disclosure requirements (Chapter 14)
- indemnification of corporate officials under corporate statutes and by agreement and directors' and officers' insurance (Chapter 15)
- duty of loyalty of corporate officials who take business opportunities in which the corporation may be interested and who compete with the corporation (Chapter 16)
- duties in corporate groups, including dealings by parent corporations with partially owned subsidiaries and buyouts of minority shareholders (Chapter 17)
- enforcement of fiduciary duties in derivative suits, including procedural requirements and the board's role in litigation on behalf of the corporation (Chapter 18)

In short, this part focuses on fiduciary duties in the context of business operations. Other chapters focus on fiduciary duties in the context of shareholder voting (Chapter 8), disclosure to shareholders (Chapter 22), securities trading by corporate insiders (Chapter 23), and changes of control (Chapter 39).

§11.1 THE CORPORATE FIDUCIARY— A UNIQUE RELATIONSHIP

§11.1.1 Analogies to Trusts and Partnerships

What is the corporate fiduciary's relationship to the corporation? Early courts analogized the corporation to a trust, the directors to trustees, and the shareholders to trust beneficiaries. But modern courts recognize that the analogy is flawed because trustees have limited discretion compared to directors.

Sometimes the corporation, particularly when closely held, has also been analogized to a partnership. But corporate fiduciaries operate in a system that prizes corporate permanence as well as centralized management and the discretion specialization entails. Although some cases have implied partner-like duties for participants in close corporations (see §27.2.2), the cases are exceptions to the broad discretion afforded corporate directors.

In the end, the most that can be said is that directors have a unique relationship to the corporation. The relationship arises from the broad authority delegated directors to manage and supervise the corporation's business and affairs, subject to the rights of shareholders to elect directors.

Duties of Other Corporate Insiders

Courts have generally imposed on corporate officers and senior executives the same fiduciary duties imposed on directors. MBCA §8.41. Those employees who are officers in name but have no actual authority, as well as other employees, have traditional duties of care and loyalty as agents of the corporation. In addition, corporate officers and employees have a duty of candor that requires them to give the corporation (the board of directors or a supervisor) information relevant to their corporate position.

In general, persons retained by the corporation do not have corporate fiduciary duties. For example, an attorney who advises a majority shareholder in an unfair squeezeout of minority shareholders is not bound by fiduciary duties to the corporation, though the attorney can be liable for tortious aiding and abetting of a fiduciary breach by the majority shareholder. See *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001) ("aiding and abetting" breaches of fiduciary duty have four elements: (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in the breach by the non-fiduciary defendants, and (iv) damages proximately caused by the breach).

§11.1.2 Theory of Corporate Fiduciary Duties

The genius of the U.S. corporation lies in its specialization of function. The corporation separates the risk-taking of investors and the decision-making of specialized managers. This separation creates an inevitable tension.

- **Management discretion.** The efficiency of specialized management suggests that managers should have broad discretion. Giving shareholders (and courts) significant oversight would undermine this premise of the corporate form. In cases of normal business decision-making, judicial abstention is appropriate.
- **Management accountability.** Entrusting management to nonowners suggests a need for substantial accountability. As nonowners, managers have natural incentives to be lazy or faithless. Although shareholder voting constrains management abuse, voting is episodic. Without supplemental limits, management discretion would ultimately cause investors to lose confidence in the corporate form. In cases of management overreaching, judicial intervention is the norm.

Corporate fiduciary law must resolve this tension. Like much of corporate law, fiduciary rules aim to minimize "agency costs"—the losses of investor-owners dealing through manager-agents.

§11.1.3 To Whom Are Fiduciary Duties Owed?

Corporate directors are said to owe fiduciary duties to the "corporation," not the particular shareholders who elected them. Some courts and many commentators assert that fiduciary rules thus proceed from a theory of maximizing corporate financial well-being by focusing on *shareholder wealth maximization*. The theory posits that any fiduciary rule—whether governing boardroom behavior or use of inside information—must maximize the value of shareholders' interests in the corporation. As residual claimants of the corporation's income stream, shareholders are the most interested in effective management. Under this theory, the corporation's other constituents such as bondholders, creditors, employees, and communities where the business operates are limited to their contractual rights and other legal protections. See *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) (finding that new borrowing by financially troubled firm did not violate rights of preferred shareholders, which "are contractual in nature").

To the extent other constituents have unprotected interests inconsistent with those of shareholders, the interests of shareholders prevail—a *shareholder primacy* approach.

In most instances, courts have said that corporate fiduciary duties run to equity shareholders. When the business is insolvent, however, these duties run to the corporation's creditors—who become the corporation's new residual claimants. See *Geyer v. Ingersoll Publications Co.,* 621 A.2d 784 (Del. Ch. 1992). When the corporation is on the verge of insolvency, the question arises whether directors should be allowed to take risks to return to solvency (for the benefit of shareholders) or avoid risks to preserve assets (for the benefit of creditors). Some cases suggest that the board's role shifts in such circumstances from being an "agent for the residual riskbearers" to owing a duty to the corporate enterprise. *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.,* No. 12150 (Del. Ch. 1991).

Dodge v. Ford Motor Co.

Despite its prevalence, the theory of shareholder wealth maximization has gaps. For example, the case most often cited as supporting the theory may actually have turned on nonshareholder concerns. In *Dodge v. Ford Motor Co.,* 170 N.W. 668 (Mich. 1919), the Michigan Supreme Court reviewed Ford Motor's decision to discontinue paying a special $10 million dividend, ostensibly to finance a new smelting plant while paying above-market wages and reducing the price of Ford cars. Minority shareholders claimed the decision was inconsistent with the fundamental purpose of the business corporation—to maximize the return to shareholders. The court agreed and faulted Henry Ford for reducing car prices and running Ford Motor as a "semi-eleemosynary institution and not as a business institution." The court ordered the special dividend, though curiously refused to enjoin Ford's expansion plans because "judges are not business experts."

At first blush, the case seemed to turn on Ford's stated view that his company "has made too much money, has had too large profits … and sharing them with the public, by reducing the price of the output of the company, ought to be undertaken." Nonetheless, more was below the surface. The plaintiff Dodge brothers (former suppliers of car chassis and motors to Ford Motor) hoped to use the special dividend to finance their own start-up car manufacturing company, and Henry Ford's dividend cutback was meant to forestall this competition, despite the attendant benefits of competition to the car-buying public and Michigan's auto industry. The court's decision to second-guess perhaps the most successful industrialist ever is at odds with the general judicial deference to management, as well as with the Michigan court's specific observation that Ford Motor's great success had resulted from its "capable management."

Using corporate law, the court advanced a social agenda. Fixing on snippets from Henry Ford's public relations posturing, the court labeled him an antishareholder altruist. This allowed the court to order Ford to fund the Dodge brothers' new car company, thus injecting some competitive balance into the expanding auto industry and ultimately into Michigan politics. Soon after, the Dodge brothers parlayed their court victory into a sizeable buyout of their Ford Motor holdings. (It is worth noting that no other minority shareholders participated in the case, though Henry Ford eventually bought them out, too.) Ironically, the case so often cited as declaring a philosophy of shareholder wealth maximization turns out—on closer examination—to have been about a squabble between two competitors where the stakes were consumer prices, product choice, employee wages, industry competition, and political pluralism.

"Other Constituency" Statutes

Some states have recently enacted "other constituency" statutes that permit, but do not require, directors to consider nonshareholder constituents (or stakeholders), particularly in the context of a corporate takeover. See Pa. BCL §1715 (directors may consider "shareholders, employees, suppliers, customers and creditors of the corporation … communities in which offices or other establishments of the corporation are located … short-term and long-term interests of the corporation"). The statutes have been controversial. Some commentators have praised them as signaling a new era of corporate social responsibility; others have criticized them as a ruse for incumbent entrenchment and fecklessness. By permitting directors to rationalize corporate decisions on such open-ended concepts as "long-term interests" and "communities where the corporation operates," the statutes appear to dilute director accountability.

Although no cases have confronted the meaning of the "other constituency" statutes, other cases give mixed signals about directorial deference to nonshareholder stakeholders. Some cases suggest directors can take stakeholders into account only if rationally related to promoting shareholder interests. See *Revlon v. MacAndrews & Forbes Holding*, 506 A.2d 173 (Del. 1986). Yet others suggest directors have significant latitude to consider "corporate culture," not just immediate shareholder returns, when responding to takeover threats. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1142 (Del. 1990).

Corporate Social Responsibility (CSR)

Over the past decade, many companies have recognized that their responsibilities extend beyond the legal duties toward shareholders and others with whom the company does business. Although not required by law, many companies (particular multinational companies) have voluntarily taken responsibility for their impact on customers, workers, communities, and other stakeholders, as well as the environment.

Companies tout their CSR activities—such as "green" initiatives or "fair labor" commitments—to bolster their reputations as corporate citizens. To show their commitment to CSR, many companies have agreed to reporting guidelines and operational standards developed by various nongovernmental organizations (NGOs). In addition, some institutional investors seek to take into account in their investment and voting decisions whether companies have implemented CSR programs.

Proponents see CSR as "applied business ethics" and a means more suited than regulatory compliance for companies and their decision-makers to internalize externalities (the costs imposed by business on others). Critics claim that CSR is superficial window dressing that companies use to divert attention from the harms they cause and to forestall government regulation.

Recently, the CSR movement has received support from various quarters. In a nod to the growing relevance to investors of environmental concerns, the SEC has issued interpretive guidance to reporting companies on their disclosure regarding climate change. Guidance on Climate Change Disclosure, Securities Act Rel. No. 9106 (2010) (pointing out the insurance industry lists climate change as the number one risk facing the industry). While not taking a stance on the climate change debate, the SEC pointed out that under existing disclosure requirements (such as management's discussion of future contingencies) companies may have to disclose material information about (1) the impact on the company's business of existing (and even pending) climate change laws; (2) the impact of international accords on climate change; (3) the actual or indirect consequences of climate change trends (such as decreased demand for carbon-intensive products or higher demand for lower-emission products); and (4) actual and potential physical impacts of environmental changes to the company's business. As some have pointed out, "what gets measured gets managed."

Congress has also added its voice on CSR issues. In 2010 the Dodd-Frank Act mandated that the SEC adopt a rule requiring disclosures by companies whose products contain "conflict minerals," such as tin, tantalum, tungsten, and gold, mined in the war-torn Democratic Republic of Congo. Under the rule adopted by the SEC, companies that use such minerals are required to examine their products and processes, and investigate the sourcing of the materials they use. See Exchange Act Release No. 67,716 (2012). In 2014, the SEC rule was successfully challenged in court as a violation of companies' First Amendment rights. *National Association of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir 2014). The court concluded that the rule's requirement that companies label their products as not "DRC conflict free" in SEC filings (and on company websites) unconstitutionally compelled speech. The court pointed to the SEC's failure to consider whether less restrictive means (besides product descriptions) could achieve the rule's intended purpose to prevent the commerce in minerals used to fund the Central African armed conflict. The court said a couple alternatives were "intuitive"—namely, that issuers could use their own language to describe their products or that the SEC could compile its own list of "conflict minerals" products based on information submitted by companies to the SEC. The court, however, upheld other aspects of the rule, including the "de minimis" exception making the rule applicable only to manufacturers the longer phase-in of the rule for smaller companies. Soon after the court ruling, the SEC stayed the part of the rule requiring the company statements held to violate the First Amendment, though the rest of the rule's investigation and disclosure requirements remained in force. Two SEC commissioners questioned the rule's effect, pointing out its unintended consequence of putting out of work one million legitimate Congolese miners when U.S. companies avoided the rule's disclosure mandates by simply stopping their purchases of minerals from the Congo.

In addition, nongovernmental organizations (such as Ceres) are organizing investor groups, environmental organizations, and other public interest groups to work with for-profit corporations to address sustainability challenges such as climate change, resource use, and water scarcity. Even as governments have been paralyzed to act, many investors and businesses in the private sector are moving ahead on sustainability initiatives. They understand that environmental and social sustainability presents risks (and opportunities) for their business and that sustainability considerations must be a part of their core business strategies if they are to achieve a competitive advantage—including corporate governance, stakeholder engagement, corporate disclosure, and performance. Some studies bear this out, finding a relationship between company sustainability performance and financial performance.

In a similar vein, the United Nations has reconceptualized the modern corporation as being quasi-governmental, with responsibilities not only to comply with law but also to respect human rights. For example, the U.N. Human Rights Council has adopted a set of guiding principles for business (known as the Ruggie Principles, for the professor who drafted them) that are designed to ensure that companies do not violate human rights in the course of their operations and provide redress when they do. The guiding principles —which place companies in the position of "private states"—lay out specific steps that companies should take to make sure they respect human rights. For example, companies are called on to undertake a "human rights due diligence," which includes impact assessment, monitoring, community engagement, and a grievance mechanism, so people who have even minor complaints against a company have a place to go to have issues addressed. The assessment should cover not only potential for adverse human rights impacts of the company's activities but also the impacts of business partners. The guidelines call on companies to use leverage to prevent or mitigate human rights abuses by business partners or to end the business relationship.

§11.2 FIDUCIARY DUTIES OF CARE AND LOYALTY

According to traditional fiduciary analysis, corporate managers owe two duties to the corporation: care and loyalty. Each duty describes standards for judicial review of corporate decision-making and fiduciary activities.

Note on Duty of Good Faith (and Obedience to Legal Norms)

Delaware courts have recently articulated a duty of "good faith" that applies when directors act *intentionally* to violate positive law, with a purpose other than the corporation's best interests, or with a conscious disregard for their duties to act. *Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (2006). The courts have said that the duty of good faith is breached when directors fail to consider the financial ramifications of an executive's contingent pay package, when directors fail to establish an oversight system to monitor the corporation's legal compliance, or when directors act as "stooges" for a controlling shareholder. The courts have explained the good faith duty as a subset of the duty of loyalty and, as such, a duty that cannot be exculpated. See Del. GCL §102(b)(7) (see §15.1).

Delaware corporate law, like that of other states, also anticipates that an aspect of the duty of good faith is that corporate directors will abide by legal norms. See *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049 (Del. Ch. 1996) (concluding that "bad faith" is presented where board approves transaction "known to constitute a violation of applicable positive law"); see also Official Comment to MBCA §8.31 (stating that "conduct involving knowingly illegal conduct that exposes the corporation to harm will constitute action not in good faith"). Thus, the duties of care and loyalty may sometimes not describe fully the corporate legal landscape. Even if disinterested directors having no personal financial stake in a transaction decided with full information and after careful deliberation that it would be in the best (financial) interests of the corporation to violate a particular legal norm, the decision would still be subject to review. In such cases, it would seem that neither the duty of care nor the duty of loyalty is breached: the directors were informed, deliberative, disinterested and seeking to benefit the corporation. Yet, there is a clear judicial consensus that decisions to knowingly violate the law are beyond the pale. See §12.3.1 (Illegality); §12.3.4 (Monitoring Illegality). It would seem that another directorial duty might be at work: a duty of obedience. Such a duty exists in non-profit corporations, and once was part of the triumvirate of fiduciary duties in for-profit corporations.

§11.2.1 Duty of Care

The duty of care addresses the attentiveness and prudence of managers in performing their decision-making and oversight functions. The famous “business judgment rule” presumes that directors (and officers) carry out their functions in good faith, after sufficient investigation, and for acceptable reasons. Unless this presumption is overcome, courts abstain from second-guessing well-meaning business decisions even when they are flops. This is a risk that shareholders take when they make a corporate investment. See Chapter 12.

To encourage directors to take business risks without fear of personal liability, corporate law protects well-meaning directors through exculpation provisions in the corporation’s articles (see §12.5), statutory and contractual indemnification (see §15.1), and directors’ and officers’ insurance (see §15.2).

§11.2.2 Duty of Loyalty

The duty of loyalty addresses fiduciaries’ conflicts of interest and requires fiduciaries to put the corporation’s interests ahead of their own—that is, fiduciaries cannot serve two masters. Corporate fiduciaries breach their duty of loyalty when they divert corporate assets, business opportunities, or proprietary information for personal gain.

Flagrant Diversion

Diversion can be as simple, and as reprehensible, as a corporate official stealing tangible corporate assets. This is a plain breach of the fiduciary’s duty of loyalty because the diversion was unauthorized and the corporation received no benefit in the transaction. Besides disaffirming the transaction as unauthorized (see §3.3.3), the corporation can sue for breach of fiduciary duty and in tort.

Self-Dealing

Diversion can be masked in a self-dealing transaction. When a fiduciary enters into a transaction with the corporation on unfair terms, the effect (from the corporation’s standpoint) is the same as if he had appropriated the difference between the transaction’s fair value and the transaction’s price. Courts, as well as statutes, address the issue when a self-dealing transaction is unfair. See Chapter 13.

A parent corporation that controls a partially-owned subsidiary can breach its duty to the minority shareholders of the subsidiary if the parent prefers itself at the expense of the minority. See §17.2. The ultimate form of preferential dealing occurs when the parent squeezes out the minority (in a merger or other transaction) and forces the minority to accept unfair consideration for their shares. See §17.3.

Executive Compensation

When a director or officer sells his executive services to the corporation, diversion can occur if the executive’s compensation exceeds the fair value of his services. See Chapter 14.

Usurping Corporate Opportunity

When a corporate fiduciary seizes for herself a desirable business opportunity that the corporation may have taken and profited from, diversion occurs if the fiduciary denies the corporation the opportunity to expand profitably. See Chapter 16.

Disclosure to Shareholders

Corporate officials who provide shareholders false or deceptive information, on which the shareholders rely to their detriment, not only undermine corporate credibility and transparency, but frustrate shareholders’ expectations of fiduciary honesty and accountability. Duties of disclosure arise when directors seek a shareholder vote (see Chapter 8—state law; Chapter 10—federal proxy fraud) and when corporate officials communicate to stock trading markets (see §21.1—state law; Chapter 22—federal Rule 10b-5).

Trading on Inside Information

When a fiduciary is aware of confidential corporate information—such as the impending takeover of another company—and he buys the target’s stock, diversion can occur if the fiduciary’s trading interferes with the corporation’s takeover plans. By the same logic, when the fiduciary trades with the company's shareholders using inside information, the fiduciary diverts to himself information belonging to the corporation. See Chapter 23.

Selling Out

A corporate official who accepts a bribe to sell her corporate office breaches a duty to the corporation. Likewise, a controlling shareholder who sells his controlling interest to a new owner who then diverts corporate assets to herself exposes the remaining shareholders to the new owner's looting. See §20.2.

Entrenchment

A manager who uses the corporate governance machinery to protect his incumbency effectively diverts control from the shareholders to himself. Besides preventing shareholders from exercising their control rights—whether by voting or selling to a new owner—management entrenchment undermines the disciplining effect on management of a robust market in corporate control. See Chapter 8 (voting manipulation); §39.2 (takeover defenses).

There is no uniform standard for judging these conflict-of-interest transactions. Some are flatly prohibited (insider trading), others receive searching judicial fairness review (squeezeouts), and others are subject to internal corporate safeguards (executive compensation).

§11.2.3 Judicial Enforcement of Fiduciary Duties

Fiduciary duties generally are said to be owed to the corporation and not to particular shareholders and must be enforced in the name of the corporation. This reflects the practical and conceptual danger of one shareholder purporting to speak for the body of shareholders. Rarely, however, are fiduciary breaches challenged by the corporation because those who abused their control are unlikely to sue themselves. Instead, fiduciary breaches usually are challenged by shareholders in derivative litigation brought on behalf of the corporation (see Chapter 18).

§11.3 FIDUCIARY DUTIES—CORPORATE

AND MARKET REALITIES

§11.3.1 Fiduciary Duties in Closely Held Corporations

In closely held corporations (those that do not have a trading market for their shares) the corporate participants often have a relationship of special trust. No market exists for their shares. Some courts have implied a duty among participants akin to that of partners. Other courts have used statutory protections against "oppression" to intervene on behalf of minority shareholders. See Chapter 27.

A frequent issue in close corporations is whether fiduciary duties can be modified by agreement. Although modern partnership law permits partners to waive fiduciary rights, courts have been less willing to see corporate fiduciary duties as default terms. Compare RUPA §103(b) (permitting partners to waive duty of loyalty as to categories of activities, if not manifestly unreasonable, and to reduce duty of care if not unreasonable). Rather, corporate fiduciary duties have been viewed as immutable aspects of the corporate relationship.

§11.3.2 Fiduciary Duties in Modern Public Corporations

In public corporations, management has three principal functions. First, directors and senior executives make "enterprise" decisions concerning operational and business matters—such as where to locate a new facility or whether to discontinue a product line. The board establishes the strategic plan; senior executives carry it out. Directors rely on the senior executives for information in establishing and monitoring the business plan. Shareholder and management interests typically overlap as to these enterprise decisions, as reflected in the deferential business judgment rule.

Second, directors act on "ownership" issues—such as initiating a merger with another company or constructing takeover defenses. Outside directors (that is, directors who are not employed by the corporation) have assumed special prominence on these issues, as courts often defer to the independent judgment of outside directors when corporate control is at stake. Although directors in public corporations once were criticized for acting as “rubber stamps” for management, directors lately have become more forceful. Spurred by activist institutional investors and the clamor after Sarbanes-Oxley, outside directors have asserted themselves by replacing CEOs, negotiating takeovers, and making themselves more accountable. Outside directors, sometimes acting in special committees, often turn to their own legal and investment advisors.

Third, directors are responsible for “oversight” of the corporation—such as reviewing senior executives’ performance and ensuring corporate compliance with legal norms. In public corporations the board often establishes compliance programs and receives regular management reports. As corporate responsibility has grown in such areas as regulatory compliance and foreign bribery, courts have increasingly insisted on higher levels of board oversight. In addition, disclosure by the company to public trading markets allows shareholders to gauge how well management is overseeing the corporation.

Management in public corporations lives under the watchful eye of the securities markets. When the market detects mismanagement, the trading price of the company’s stock falls. This makes it attractive for outside bidders or shareholder insurgents to acquire control and oust the ineffective management. In extreme cases, a collapse in the stock price signals to creditors that the company is insolvent and should be put in the hands of a bankruptcy court. Fiduciary norms take these corrective mechanisms into account, relaxing scrutiny when control markets are available to discipline poor management and tightening scrutiny when the board attempts to insulate itself from these markets.

Note on “Imperial CEO”

In the United States *corporate management* in public corporations often refers to the Chief Executive Officer (CEO), whose vision and leadership make him or her the ultimate manager of the company. In most companies, investors focus on outside directors only when something goes wrong. The CEO puts together a management team—including a Chief Operating Officer (COO), Chief Financial Officer (CFO), and Chief Legal Officer (CLO or General Counsel)—to oversee

> and run the company's business. Generally, investors and employees look to the CEO as the symbol of ultimate authority for the company. This is not, of course, what the law says. But the reality is that outside directors, chosen through a nominating process often heavily influenced by the CEO, have few incentives to be suspicious or adversarial. They are mostly dependent on the CEO's management team for information and analysis. Strategy is typically developed by the management team in internal discussions and then presented to the board for approval.

§11.4 INDEPENDENT DIRECTORS

Over the last several years, directors who do not have an employment relationship with the corporation—so-called independent directors—have assumed increased prominence in U.S. public corporations. The accounting and financial scandals that came to light in the early 2000s focused attention on the failures of outside directors to monitor and oversee corporate management. Paradoxically, the response has been to assign even greater importance to independent directors. Empirical studies are mixed on whether outside directors increase company profitability and whether they have an effect on controlling management excesses.

Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 (described in §11.5.1) specifies the responsibilities of independent directors on the audit committees of public corporations. As required by Sarbanes-Oxley, stock exchanges have adopted listing standards that specify the composition and functions of the audit committees of listed companies (including foreign issuers and small business issuers). Under these standards, audit committees must be composed entirely of independent directors, as defined by the SEC.

In addition, all reporting companies must disclose whether at least one member of the audit committee is a financial expert. Sarbanes-Oxley §407, Reg. S-K, Item 401 (defining "audit committee financial expert" as one with significant auditing, accounting, financial, or comparable experience).

In addition, the exchanges' governance listing standards must also specify that the audit committee of listed companies be responsible for appointing, compensating, and overseeing the company’s independent audit firm—a curtailment of the power of the full board and shareholders over outside accountants. The audit committee (not the board) must have the authority to hire independent counsel and other advisors, their fees to be paid by the listed company. Rule 10A-3; Exchange Act Rel. No. 47,654 (2003).

Dodd-Frank

The Dodd-Frank Act of 2010 (described in §11.5.2) also intrudes into the boardroom of public corporations, requiring the stock exchanges to adopt listing standards that require all the directors on the corporation’s compensation committee to be independent. Dodd-Frank §952. The committee must also have the authority to hire independent compensation consultants.

Delaware

State courts, particularly in Delaware, have increasingly deferred to independent directors in various contexts. Delaware courts review deferentially corporate transactions in which management has a conflicting interest if a majority of the board is composed of directors who are *disinterested* (no conflicting financial interest in the transaction) and *independent* (neither beholden to interested party because of financial or business relationships, nor dominated by interested party through family or social relationships). See *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002) (distinguishing between “interest” and “independence” of directors).

Delaware courts focus on director independence in deciding whether

- to shift the burden to the challenging shareholder in transactions involving management conflicts. See §13.3.3 (director self-dealing transactions), §17.3.3 (squeeze-out mergers).
- to review executive pay under a waste standard, rather than the more burdensome fairness standard. See §14.2.3 (executive compensation).
- to indemnify corporate officials who become liable or settle claims arising from their corporate position. See §15.1.2 (permissive indemnification).
- to approve settlement of derivative litigation. See *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991) (approving settlement of claim that company had

wasted corporate assets in donating money for art museum to house CEO's personal art collection).

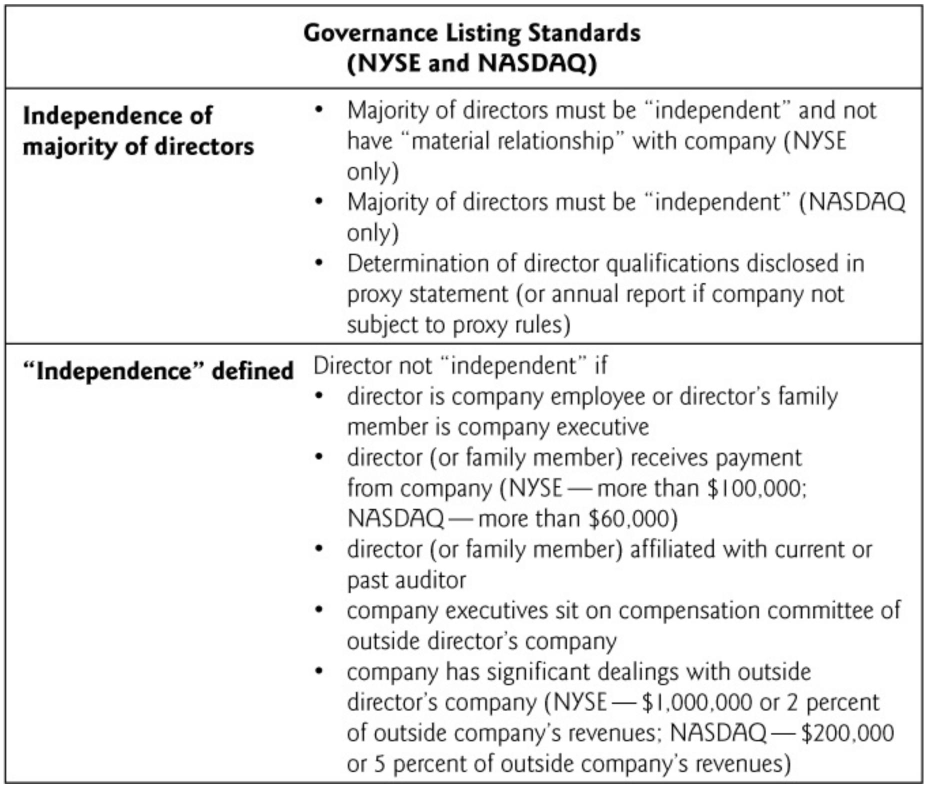
- to dismiss shareholder derivative litigation, either on the basis of "demand futility" or recommendations of a special litigation committee. See §18.5.3 (demand requirement), §18.5.4 (special litigation committee).
- to uphold antitakeover measures (whether in anticipation of unwanted bids or in response to particular threats) and deal protection measures. See §8.2.2 (shark repellents), §39.2.3 (takeover defenses), §39.2.4 (deal protections).

Delaware courts have recently shown more willingness to inquire into the social and business relationships between outside directors and management—to test whether there exists implicit directorial bias. For example, the Delaware Chancery Court questioned the independence of a tenured Stanford law professor, who as a member of a special litigation committee was asked to determine whether suit should be brought against various corporate executives who allegedly had engaged in insider trading. The court concluded the professor's and executives' close and overlapping ties to Stanford—as large donors, fellow professors, and members of a university policy institute—suggested an institutional context in which motives of "friendship and collegiality" could not be ignored. *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003). But the Delaware Supreme Court has stopped short of saying that social and business relationships alone undermine independence. See *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) (finding directors sufficiently "independent" in demand-futility case, despite longstanding personal friendships and close business relationships to CEO, who held 94 percent of the company's voting power).

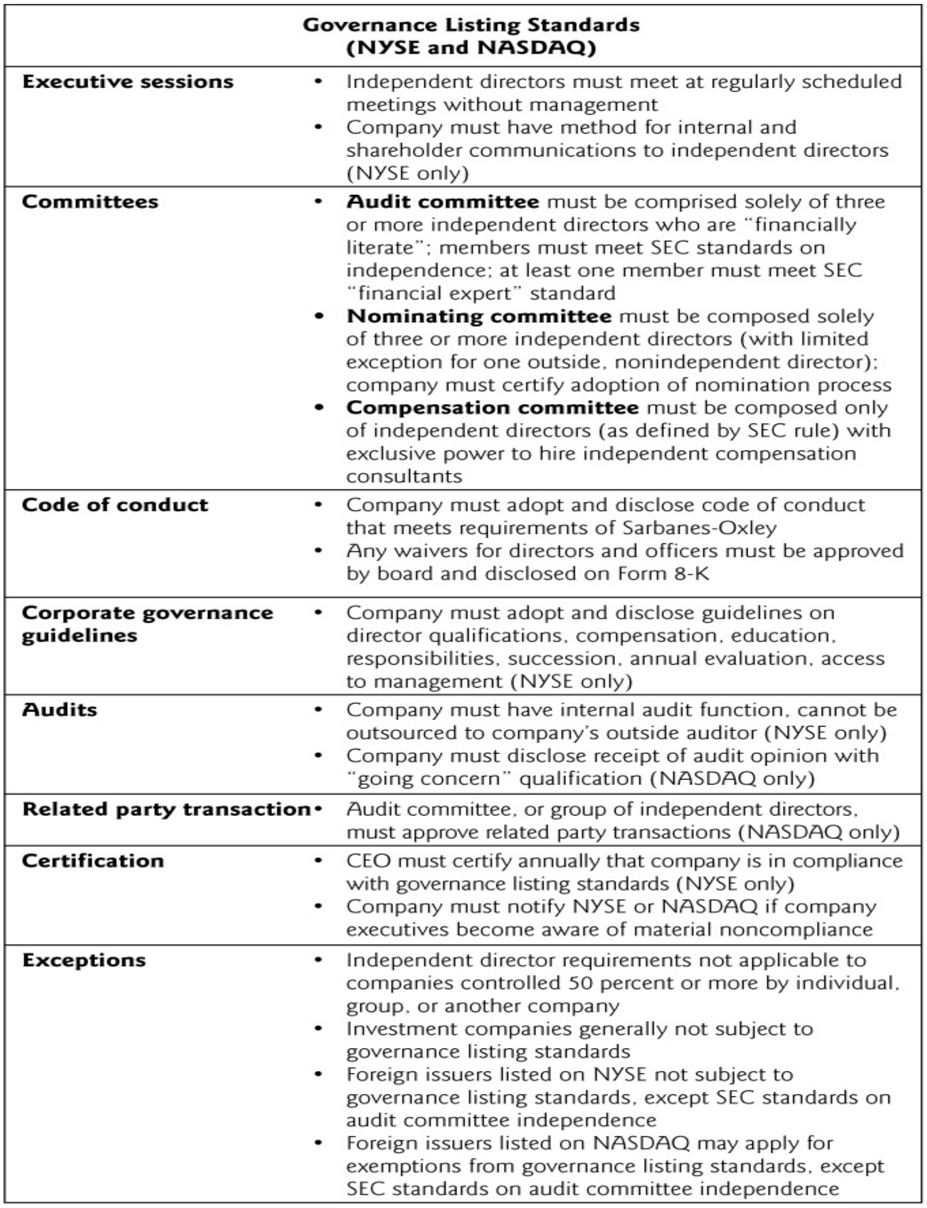
The MBCA goes one step further and makes lack of independence a basis for imposing liability on directors in an interested-party transaction. See MBCA §8.31(a)(2)(iii) (making director liable if director's judgment is affected because of a lack of objectivity due to director's familial, financial, or business relationship with interested person or a lack of independence due to director's domination or control by interested person). Upon such a showing, the director has the burden to prove that he reasonably believed the challenged conduct was in the best interests of the corporation. MBCA §8.31(a)(2)(iii)(B).

Corporate Governance in Stock Listing Standards

The New York Stock Exchange and the NASDAQ have adopted standards that compel listed companies to adopt corporate governance structures that emphasize “independent directors.” In many instances, these listing standards are mandated by Sarbanes-Oxley and Dodd-Frank:



Governance Listing Standards (NYSE and NASDAQ)	
Independence of majority of directors	• Majority of directors must be “independent” and not have “material relationship” with company (NYSE only) • Majority of directors must be “independent” (NASDAQ only) • Determination of director qualifications disclosed in proxy statement (or annual report if company not subject to proxy rules)
“Independence” defined	Director not “independent” if • director is company employee or director’s family member is company executive • director (or family member) receives payment from company (NYSE — more than $100,000; NASDAQ — more than $60,000) • director (or family member) affiliated with current or past auditor • company executives sit on compensation committee of outside director’s company • company has significant dealings with outside director’s company (NYSE — $1,000,000 or 2 percent of outside company’s revenues; NASDAQ — $200,000 or 5 percent of outside company’s revenues)



Governance Listing Standards (NYSE and NASDAQ)	
Executive sessions	• Independent directors must meet at regularly scheduled meetings without management • Company must have method for internal and shareholder communications to independent directors (NYSE only)
Committees	• **Audit committee** must be comprised solely of three or more independent directors who are "financially literate"; members must meet SEC standards on independence; at least one member must meet SEC "financial expert" standard • **Nominating committee** must be composed solely of three or more independent directors (with limited exception for one outside, nonindependent director); company must certify adoption of nomination process • **Compensation committee** must be composed only of independent directors (as defined by SEC rule) with exclusive power to hire independent compensation consultants
Code of conduct	• Company must adopt and disclose code of conduct that meets requirements of Sarbanes-Oxley • Any waivers for directors and officers must be approved by board and disclosed on Form 8-K
Corporate governance guidelines	• Company must adopt and disclose guidelines on director qualifications, compensation, education, responsibilities, succession, annual evaluation, access to management (NYSE only)
Audits	• Company must have internal audit function, cannot be outsourced to company's outside auditor (NYSE only) • Company must disclose receipt of audit opinion with "going concern" qualification (NASDAQ only)
Related party transaction	• Audit committee, or group of independent directors, must approve related party transactions (NASDAQ only)
Certification	• CEO must certify annually that company is in compliance with governance listing standards (NYSE only) • Company must notify NYSE or NASDAQ if company executives become aware of material noncompliance
Exceptions	• Independent director requirements not applicable to companies controlled 50 percent or more by individual, group, or another company • Investment companies generally not subject to governance listing standards • Foreign issuers listed on NYSE not subject to governance listing standards, except SEC standards on audit committee independence • Foreign issuers listed on NASDAQ may apply for exemptions from governance listing standards, except SEC standards on audit committee independence

§11.5 FEDERALIZATION OF CORPORATE GOVERNANCE

Although corporate fiduciary duties arise mostly under state law, federal law has come to play an important role in corporate governance of public corporations. Since the 1930s, federal securities regulation has imposed disclosure requirements that compel corporate fiduciaries in public corporations to reveal information about the operational and financial details of the business as well as the roles of the fiduciaries in the corporation. Thus, corporate fiduciaries in public companies must disclose information to new public shareholders (see Chapter 5) when shareholders vote (see Chapter 9) and when shareholders tender their shares (see Chapter 38). Corporate fiduciaries also face restrictions on their ability to trade in company shares while in the possession of nonpublic material information (see Chapter 23). But, with rare exceptions, the federal regulatory scheme has been premised on disclosure to shareholders.

Recently, federal law has expanded beyond requiring corporate disclosures. The corporate scandals of the early 2000s and the financial crisis of 2008 have caused Congress to rethink the place of federal law in corporate governance of public corporations. In 2002 Congress responded to the misdeeds at companies like Enron and WorldCom by enacting the Sarbanes-Oxley Act, which revamped the regulation of the accounting profession and imposed a variety of new rules on the boards of directors and officers of public companies. In 2010 Congress responded to the financial crisis in the banking sector by enacting the Dodd-Frank Act, not only to reregulate the financial markets but also to add new rules on corporate governance and executive compensation in all public companies.

Note on Securities Regulation

In keeping with the traditional demarcation of corporate law and securities regulation in the United States, this book considers the aspects of Sarbanes-Oxley that deal with corporate governance. Those reforms that address disclosure to investors—securities regulation—are left to other sources. See Alan R. Palmiter, *Securities Regulation: Examples & Explanations* (6th ed. Wolters Kluwer Law & Business 2014).

§11.5.1 Sarbanes-Oxley Act of 2002

Responding to the accounting and corporate scandals of the early 2000s, Congress passed sweeping legislation that departs in many instances from the disclosure-based philosophy of the federal securities laws. The Public Company Accounting Reform and Investor Protection Act of 2002 (known as the Sarbanes-Oxley Act, after its congressional sponsors) seeks both to strengthen the integrity of the federal securities disclosure system and to federalize specific aspects of public corporation law.

Story of Enron

The story of Enron's rise and fall is an inextricable part of Sarbanes-Oxley. An energy trading company that started as a stodgy natural gas pipeline, Enron grew dramatically during the 1990s to become the seventh-largest corporation in the United States by market capitalization. Its innovative business model, widely lauded and studied, involved the creation of a freewheeling trading market in wholesale energy and transmission (with appurtenant risk management and financial hedging products).

At first the new market and Enron thrived. But as competitors imitated its model, Enron had to look for new ways to maintain its constantly growing profits. Its executives devised two main techniques: (1) Enron entered into paper transactions with special-purpose entities that created the appearance of revenues on Enron's financial statements, and (2) Enron financed these related entities with loans (secured by its high-priced stock) that were not reported as debt on Enron's balance sheet. In short, Enron began trading with itself and placing bets on its common stock.

Both the related-entity transactions (in which high-placed Enron executives held personal investments) and their accounting treatment received the blessing of the Enron board of directors, its auditing firm Arthur Andersen, and its outside law firm Vinson & Elkins. Also, securities firms that participated in financing Enron's related entities pressured their securities analysts to recommend the company's stock. Rather than question anomalies in its financial statements, the investment community awarded Enron with accolades and an ever-increasing stock price.

In 2001 Enron's stock price began to slip as investors became suspicious of its related-entity dealings. As federal investigators began their probes, Enron's auditor publicly vouched for the company's financial statements, while privately shredding incriminating documents. In late 2001, Enron restated its financials for the previous four years and, with a few pencil strokes, reduced its net income by $600 million and increased its debt by $628 million. Bankruptcy soon followed.

Although many in the financial (and political) community decried Enron as a "bad apple," the true impetus for legislative reform came from the almost weekly revelations in late 2001 and early 2002 of new financial scandals at other companies. Some had reported not actual earnings but predicted *pro* *forma* earnings. Some had treated payments for phone capacity as an investment, not a current expense—thus overstating both assets and net earnings. Some had engaged in paper buy-sell transactions to report immediate revenues while amortizing costs. The final straw came when WorldCom, the second-largest U.S. telecommunications company and operator of MCI, announced that $7 billion the company had reported as assets should have been treated as operating costs. Within weeks the company declared bankruptcy, and a few weeks later Congress passed Sarbanes-Oxley.

Pavlovian Response to Enron

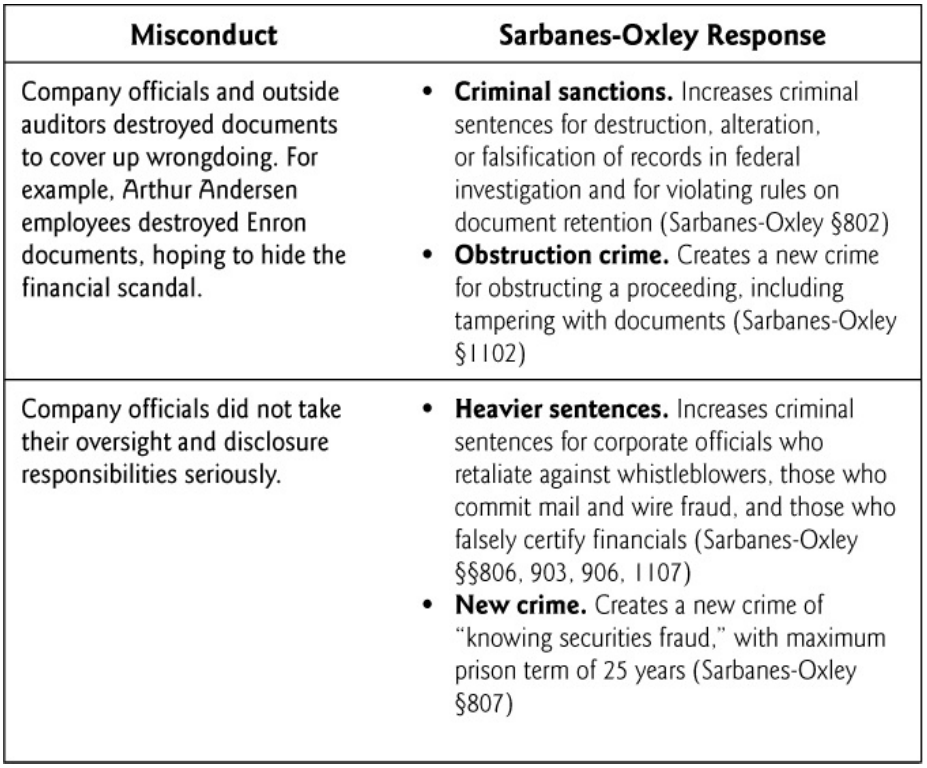
Sarbanes-Oxley reads like a Pavlovian response to the stories of business and financial misconduct revealed in congressional hearings into the collapses at Enron, WorldCom, and a slew of other companies—most in the overbuilt telecom industry. Consider the list of corporate misconduct revealed to Congress and the regulatory responses in Sarbanes-Oxley:

Misconduct	Sarbanes-Oxley Response
Outside auditors failed to discover or report accounting fraud. Some attributed this failure to self-regulation of the accounting profession, which during the 1990s relied on technicalities to satisfy clients. In particular, the accounting firm Arthur Andersen (auditor for many scandal-ridden companies) was passive toward financial irregularities at many clients.	• **PCAOB.** Creates a self-regulatory, five-person Public Company Accounting Oversight Board to establish auditing standards and regulate accounting profession (Sarbanes-Oxley §101) • **Auditor registration.** Requires accounting firms that audit public companies to register with PCAOB (Sarbanes-Oxley §102) • **Audit standards.** Authorizes PCAOB to set standards for public company audits and to enforce its audit rules (Sarbanes-Oxley §§103, 104, 105) • **Auditor sanctions.** Authorizes SEC to sanction auditors for intentional, reckless, and highly negligent conduct (Sarbanes-Oxley §602)
Outside auditors performed nonaudit services that undermined their audit independence. For example, Arthur Andersen came to earn more from Enron for its nonaudit services than for its work as financial auditor.	• **Nonaudit services.** Bans auditors from providing certain types of nonaudit services and requires preapproval by the company's audit committee of permissible nonaudit services (Sarbanes-Oxley §§201, 202)
Outside auditors became too "cozy" with executives of audit clients. For example, many financial officers of Enron were former principals of Arthur Andersen, its auditor.	• **Auditor rotation.** Requires rotation of audit partner every five years (Sarbanes-Oxley §203) • **Revolving door.** Closes "revolving door" for members of audit team who within one year after engagement become financial/accounting officers of audit client (Sarbanes-Oxley §206)

Misconduct	Sarbanes-Oxley Response
Corporate boards (especially board audit committees) failed to supervise outside auditors and lacked expertise to understand the company's finances. The Enron board became a symbol of directorial inattention.	• **Audit committee composition.** Authorizes SEC to have stock exchanges change their listing requirements to require audit committees composed only of independent directors, with full authority over outside auditor (Sarbanes-Oxley §301 — see §11.4) • **Financial expert.** Requires disclosure whether company has at least one "financial expert" on audit committee (Sarbanes-Oxley §407 — see §12.3.5)
Corporate executives failed to ascertain the truthfulness of company filings and to supervise subordinates and pressured auditors to give "clean" reports.	• **Officer certification.** Requires SEC rules that CEO and CFO certify that SEC filings are true, complete, and fairly presented (Sarbanes-Oxley §302 — see §21.2.2) • **Internal controls.** Requires SEC rules on disclosure of internal controls, and requires top executives to certify them (Sarbanes-Oxley §404 — see §12.3.5) • **Auditor influence.** Prohibits company officials from improperly influencing outside auditors (Sarbanes-Oxley §303)
Companies failed to report (and the SEC failed to notice) their true financial condition, especially the potential effect of risky off-balance sheet arrangements.	• **Real-time disclosures.** Requires companies to make additional, real-time disclosures in "plain English" of current changes to financial condition (Sarbanes-Oxley §409 — see §21.2.2) • **Off-balance sheet transactions.** Mandates SEC rules requiring disclosure of all material off-balance sheet arrangements (Sarbanes-Oxley §401) • **SEC review.** Requires SEC to review filings by reporting companies at least every three years (Sarbanes-Oxley §408)
Corporate cultures encouraged irresponsible behavior, such as unauthorized or excessive loans to company executives. For example, at Adelphia the family of the company founder received $3.1 billion in loans and other benefits while the company was reporting large financial losses.	• **Code of ethics.** Requires disclosure whether the company has a code of ethics applicable to senior financial officers or justify why not (Sarbanes-Oxley §406 — see §12.3.5) • **Director and officer bans.** Authorizes SEC to remove "unfit" officers and directors from their positions and bar them from similar offices in other public companies (Sarbanes-Oxley §§305, 1105) • **Personal loans.** Forbids "personal loans" to company directors and officers, except in regular course of company's lending business (Sarbanes-Oxley §402–§14.4.2)

(continued)

Misconduct	Sarbanes-Oxley Response
Corporate executives sold company stock while aware of accounting misinformation and while employees in the company's pension plan could not sell.	• **Clawbacks.** Requires forfeiture of executive pay and trading gains when company restates financials due to misconduct (Sarbanes-Oxley §304 — see §§14.4.2, 23.4.2) • **Blackout periods.** Bars company executives from selling stock during any trading blackout period imposed on employees (Sarbanes-Oxley §306 — see §23.4.1) • **Insider reports.** Requires corporate insiders to disclose their trading in company stock within two business days (Sarbanes-Oxley §403 — see §24.2)
Outside securities lawyers "papered" illegal transactions or failed to intercede to stop company wrongdoing.	• **Up-the-ladder reporting.** Mandates SEC rules requiring lawyers working for public company to report securities violations and fiduciary breaches up the internal corporate ladder (Sarbanes-Oxley §307 — see §12.3.5) • **Lawyer malpractice.** Authorizes SEC to bring enforcement actions against lawyers for malpractice (Sarbanes-Oxley §602)
Securities analysts prepared biased research reports for companies with whom their securities firms did business.	• **Analyst reports.** Mandates SEC to adopt rules on the independence and objectivity of securities analysts and protect them from retaliation for negative reports or ratings (Sarbanes-Oxley §501)
Many frauds only came to light because of courageous "whistle-blowers" inside the company.	• **Whistleblower protection.** Imposes criminal liability on those who retaliate against employees (whistleblowers) who provide evidence or assist in the investigation of business crimes (Sarbanes-Oxley §1107 — see §12.3.5) • **Whistleblower action.** Creates an administrative redress for whistleblowers who experience retaliation to seek compensatory damages, reinstatement, back pay, litigation costs (Sarbanes-Oxley §806 — see §12.3.5) • **Hotlines.** Requires audit committees to create procedures for handling (anonymous) complaints about accounting improprieties (Sarbanes-Oxley §301 — see §12.3.5) • **Statute of limitations.** Extends statute of limitations in cases of securities fraud to two years from discovery or five years from violation (Sarbanes-Oxley §804 — see §22.4.1)



Misconduct	Sarbanes-Oxley Response
Company officials and outside auditors destroyed documents to cover up wrongdoing. For example, Arthur Andersen employees destroyed Enron documents, hoping to hide the financial scandal.	• **Criminal sanctions.** Increases criminal sentences for destruction, alteration, or falsification of records in federal investigation and for violating rules on document retention (Sarbanes-Oxley §802) • **Obstruction crime.** Creates a new crime for obstructing a proceeding, including tampering with documents (Sarbanes-Oxley §1102)
Company officials did not take their oversight and disclosure responsibilities seriously.	• **Heavier sentences.** Increases criminal sentences for corporate officials who retaliate against whistleblowers, those who commit mail and wire fraud, and those who falsely certify financials (Sarbanes-Oxley §§806, 903, 906, 1107) • **New crime.** Creates a new crime of "knowing securities fraud," with maximum prison term of 25 years (Sarbanes-Oxley §807)

Disclosure versus Corporate Governance

Many of the congressional responses in Sarbanes-Oxley sought to strengthen disclosure—the heart of federal securities regulation. For example, the rules affecting auditors sought to revitalize auditor independence; the requirements for audit committees and certifications of SEC filings by company executives sought to focus corporate attention on proper disclosure; the requirements on internal controls, the encouragement of whistleblowers, and the "up-the-ladder" reporting by securities lawyers sought to deter and detect securities fraud. In each case, the ultimate goal was to improve the integrity of the disclosure system and to lower the risk of fraud.

Other congressional responses, however, ventured into waters previously uncharted by federal securities law. By specifying board functions and regulating specified corporate transactions, Sarbanes-Oxley moved into areas of corporate governance historically within the domain of state corporate law. For example, the provisions that specify the composition and responsibilities of board audit committees, the restrictions on loans to corporate executives, the forfeiture of executive pay after financial restatements, and limitations on trading by executives during blackout periods have traditionally been subjects of state corporate statutes and fiduciary law. The reforms aimed to reshape the corporate culture of public corporations.

Evaluation of Sarbanes-Oxley

How effective have the new accounting, internal controls, ethics codes, and compliance structures called for by Sarbanes-Oxley been? Many businesses, particularly smaller public companies, complained that the heavy compliance costs of the Act were not worth the marginal benefits. (And the Dodd-Frank Act codified the SEC approach to exempt small public companies from the Sarbanes-Oxley §404 requirement that an auditor attest to the company's internal controls. See Dodd-Frank §989G.) Others have commented on how Sarbanes-Oxley changed attitudes toward corporate governance, with both insiders and outside gatekeepers in public corporations more sensitive to their responsibilities.

Some public companies claimed that the costs of remaining public were too high after Sarbanes-Oxley and "went private" by using private capital to buy their public shares. The companies said that the costs of internal controls and other corporate governance mechanisms required by Sarbanes-Oxley made private financing less expensive than public financing. Nonetheless, many (if not most) of these companies continued to be subject to the reporting requirements of the federal securities laws (including Sarbanes-Oxley) when they issued publicly traded debt to repurchase their public equity. The claims about the excessive regulatory costs of Sarbanes-Oxley may have been political grandstanding.

Academic commentators have also debated the merits of the legislation. Some see it as part of the centuries-old cycle of capital market booms and busts, inevitably followed by a frenzy of regulation—in this case, perhaps unnecessary, ill-conceived, or even counterproductive. Others assert that except for the creation of a new regulatory structure for the accounting profession the legislation merely codified reforms already underway by the stock exchanges, the SEC, sentencing authorities, and state judges. Yet even if Sarbanes-Oxley was superfluous, some have found value in its signaling of the government's resolve to address improper corporate behavior.

Empirical studies indicate that investors have responded favorably to some of the Sarbanes-Oxley initiatives. According to one study, investors have shown greater confidence in the information contained in SEC filings certified by company officers (as mandated by Sarbanes-Oxley) compared to prior uncertified filings. Another study finds that questionable "management" of accounting earnings, which increased steadily from 1987 to 2001, decreased after the enactment of Sarbanes-Oxley, with a resulting greater reliance by investors on reported earnings. Most remarkable was the steady rise after the Act's enactment in corporate restatements of financial results, as corporate managers and accountants sought to correct errors large and small. More recently, corporate financial restatements by public companies (particularly larger companies) have been on the decline, suggesting that the audit function and internal controls may be working.

§11.5.2 Dodd-Frank Act of 2010

In the fall of 2008, the U.S. financial markets nearly collapsed. Banks stopped lending, investors dumped their securities, and the U.S. economy stumbled badly. The reasons for the collapse are still being debated, but the most popular culprit has been the "housing bubble" of the 2000s. Trillions of dollars went to finance unsustainable (subprime) mortgage loans, many of which ended up in the portfolios of the leading financial institutions in this country and abroad.

In response, Congress enacted the Wall Street Reform and Consumer Protection Act (known as the Dodd-Frank Act, after its principal congressional sponsors) to reform the U.S. financial system. Most of Dodd-Frank's reform agenda was focused on the systemic risks in the financial system, the stability of financial institutions, and the investment and lending practices of U.S. banks. But Dodd-Frank also took aim at corporate governance in public corporations—primarily by expanding the voting rights of shareholders and increasing the responsibilities in public companies regarding executive compensation.

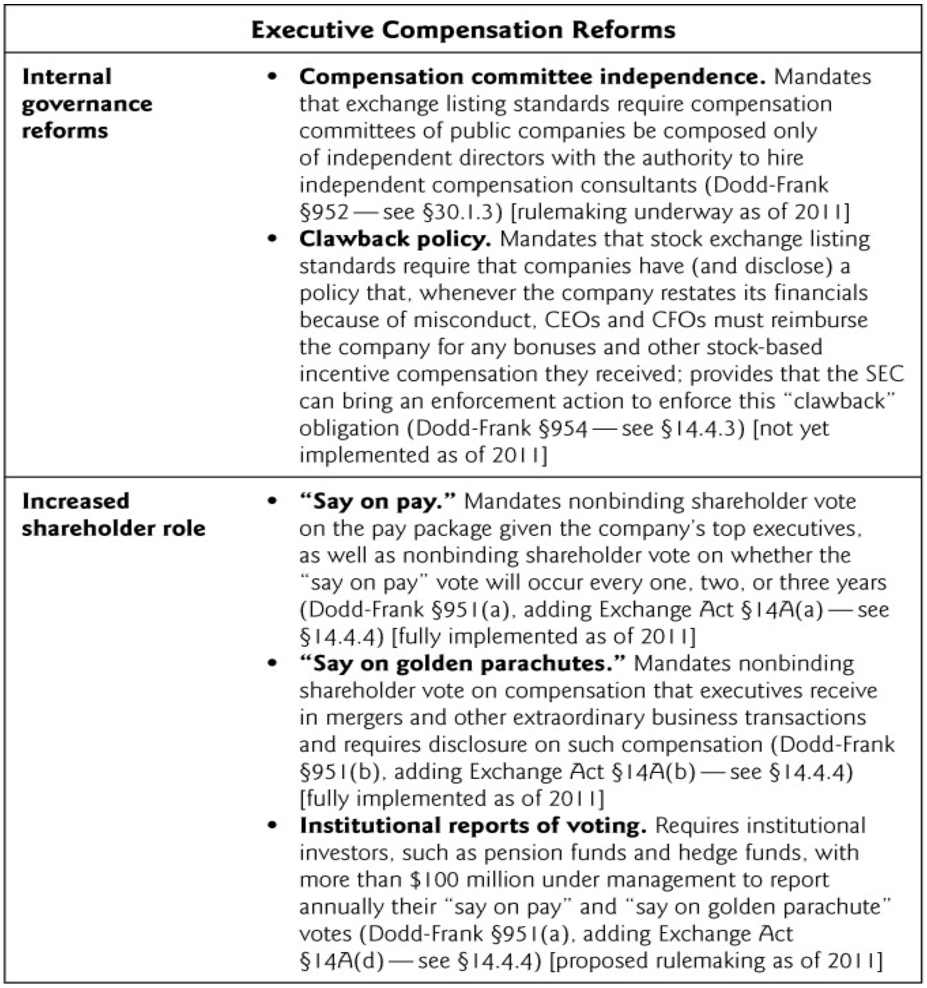
Dodd-Frank is a massive piece of legislation, running 2,300 pages in length with 240 rulemaking directives to the SEC and other regulatory agencies (some of them new agencies) and 89 additional directives to these agencies to issue reports and conduct studies. Under Dodd-Frank, the SEC alone must adopt 95 new rules and prepare 22 reports—by comparison, Sarbanes-Oxley required only 14 new rules and 1 study by the SEC. The success of Dodd-Frank, as you can see, will depend on how the regulators carry out these directives.

Corporate Governance Reforms

Some of the corporate governance reforms introduced by Dodd-Frank sought to invigorate shareholder voting in public companies (eliminate broker voting and allow shareholders to nominate directors); others sought to foster further board independence (disclosure about separating chair and CEO positions and mandating independent directors on the board's compensation committee); and others sought to fine-tune the Sarbanes-Oxley reforms (exemption of small companies from internal controls and additional protection of whistleblowers). The Dodd-Frank corporate governance agenda, however, focused most of its attention on executive compensation in public corporations (expand disclosure, require independent compensation committees, mandate shareholder advisory votes on executive pay and golden parachutes).

Here is an overview of the Dodd-Frank corporate governance and executive compensation reforms, along with a notation of the status of their implementation as of the end of 2011:

Corporate Governance Reforms	
Shareholder voting reforms	• **Broker votes.** Requires national stock exchanges to prohibit voting by nonbeneficial owners (brokers), unless they have been specifically instructed to do so by the beneficial owner (Dodd-Frank §957 amending Exchange Act §6(b) — see §6.2.1) [partially implemented as of 2011] • **Proxy access.** Authorizes the SEC to issue rules that would specify the conditions for shareholders in public companies to access the company's proxy materials to nominate directors to the board (Dodd-Frank §971, amending Exchange Act §14(a) — see §9.4.3) [SEC rule withdrawn]
Oversight within corporation	• **Disclosure CEO/chairman role.** Mandates that the SEC adopt rules requiring public companies to disclose whether the CEO and board chair are the same person and, if so, the reasons for doing so (Dodd-Frank §972 — see §9.4.2) [no proposed rules as of 2011] • **Internal controls exemption**. Exempts small business issuers (public companies with less than $75 million in market capitalization) from the Sarbanes-Oxley §404 requirement that an auditor attest to their internal financial controls and calls for the SEC to study how to reduce the compliance burden on companies with a market capitalizations of $75–$250 million (Dodd-Frank §989G — see §12.3.5) [fully implemented as of 2011]
Whistleblower protection	• **Increased protections.** Strengthens private action for whistleblowers against employers who retaliate against them, including remedies for reinstatement and double back pay (Dodd-Frank §924, amending Exchange Act 21F-1 — see §12.3.5) • **Increased bounties**. Mandates new SEC program under which employees and others who report securities violations in a company can be rewarded between 10 and 30 percent of the funds recovered based on the information provided (Dodd-Frank §§922–924, amending Exchange Act 21F — see §12.3.5) [fully implemented as of 2011]
Executive Compensation Reforms	
Additional compensation disclosure	• **Pay for performance.** Mandates SEC rules requiring additional disclosure and charts comparing executive pay to stock performance over a five-year period (Dodd-Frank §953 — see §14.4.4) • **Pay gap.** Mandates SEC rules comparing CEO pay and median pay of all of the company's employees (Dodd-Frank §953 — see §14.4.4)



Executive Compensation Reforms	
Internal governance reforms	- **Compensation committee independence.** Mandates that exchange listing standards require compensation committees of public companies be composed only of independent directors with the authority to hire independent compensation consultants (Dodd-Frank §952 — see §30.1.3) [rulemaking underway as of 2011] - **Clawback policy.** Mandates that stock exchange listing standards require that companies have (and disclose) a policy that, whenever the company restates its financials because of misconduct, CEOs and CFOs must reimburse the company for any bonuses and other stock-based incentive compensation they received; provides that the SEC can bring an enforcement action to enforce this "clawback" obligation (Dodd-Frank §954 — see §14.4.3) [not yet implemented as of 2011]
Increased shareholder role	- **"Say on pay."** Mandates nonbinding shareholder vote on the pay package given the company's top executives, as well as nonbinding shareholder vote on whether the "say on pay" vote will occur every one, two, or three years (Dodd-Frank §951(a), adding Exchange Act §14A(a) — see §14.4.4) [fully implemented as of 2011] - **"Say on golden parachutes."** Mandates nonbinding shareholder vote on compensation that executives receive in mergers and other extraordinary business transactions and requires disclosure on such compensation (Dodd-Frank §951(b), adding Exchange Act §14A(b) — see §14.4.4) [fully implemented as of 2011] - **Institutional reports of voting.** Requires institutional investors, such as pension funds and hedge funds, with more than $100 million under management to report annually their "say on pay" and "say on golden parachute" votes (Dodd-Frank §951(a), adding Exchange Act §14A(d) — see §14.4.4) [proposed rulemaking as of 2011]

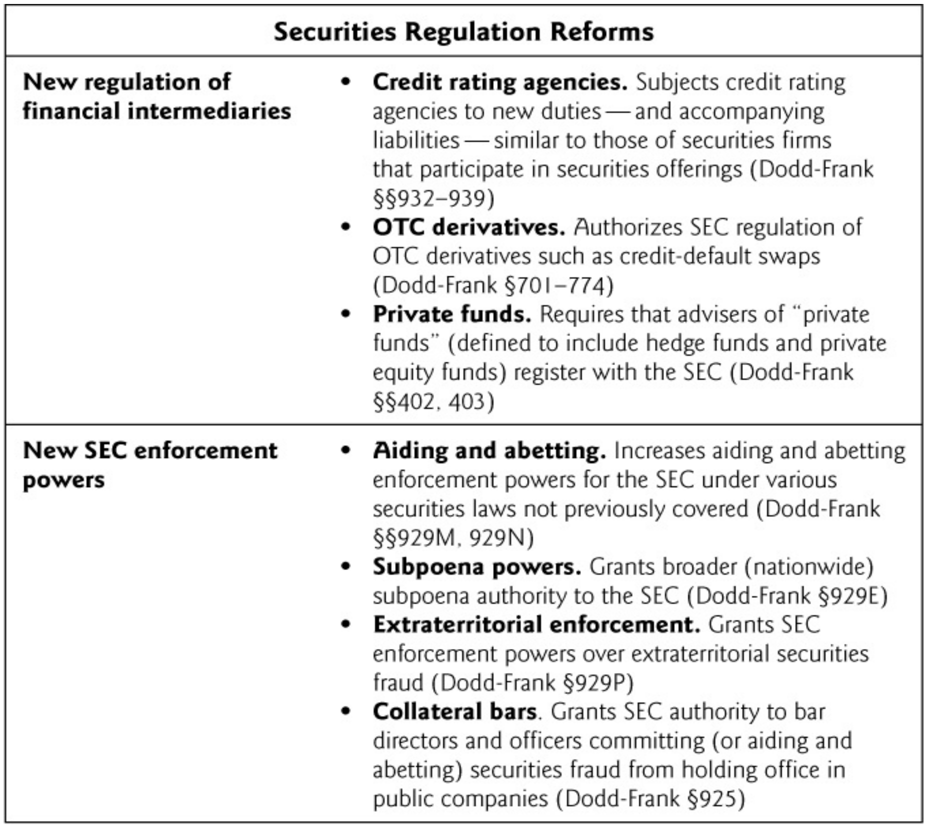
As you can see, Dodd-Frank imposes significant regulatory requirements on public companies that intrude into areas once reserved for state law and company-by-company implementation. Some provisions, such as the creation of "clawback" policies, continue regulatory requirements first imposed by Sarbanes-Oxley. Others, such as shareholder voting on executive pay and nomination of directors through the company's proxy, are federal innovations. One of the more interesting aspects of these corporate governance reforms is that many of them came, for the first time, in response to the clamor of institutional investors, primarily activist pension funds.

Securities Regulation Reforms

The financial regulatory reforms of Dodd-Frank include many that affect traditional securities regulation. Some of the reforms create new regulation for financial intermediaries that had been only lightly regulated before (such as credit rating agencies, hedge funds, and private equity funds). Other reforms regulate new categories of financial instruments—such as credit-default swaps—forcing their trading on transparent exchanges.

Reflecting a concern that SEC regulation had been too lax, the agency received new enforcement powers and directives to provide greater protection to investors in private markets. The relationship between broker-dealers and their customers came under scrutiny, with a call for the SEC to consider subjecting broker-dealers to the same fiduciary standards as investment advisers and limiting the scope of predispute arbitration agreements in broker-customer disputes.

Here is a list of the more prominent Dodd-Frank reforms of securities regulation:



Securities Regulation Reforms	
New regulation of financial intermediaries	• **Credit rating agencies.** Subjects credit rating agencies to new duties — and accompanying liabilities — similar to those of securities firms that participate in securities offerings (Dodd-Frank §§932–939) • **OTC derivatives.** Authorizes SEC regulation of OTC derivatives such as credit-default swaps (Dodd-Frank §701–774) • **Private funds.** Requires that advisers of "private funds" (defined to include hedge funds and private equity funds) register with the SEC (Dodd-Frank §§402, 403)
New SEC enforcement powers	• **Aiding and abetting.** Increases aiding and abetting enforcement powers for the SEC under various securities laws not previously covered (Dodd-Frank §§929M, 929N) • **Subpoena powers.** Grants broader (nationwide) subpoena authority to the SEC (Dodd-Frank §929E) • **Extraterritorial enforcement.** Grants SEC enforcement powers over extraterritorial securities fraud (Dodd-Frank §929P) • **Collateral bars**. Grants SEC authority to bar directors and officers committing (or aiding and abetting) securities fraud from holding office in public companies (Dodd-Frank §925)

Securities Regulation Reforms

Protection of sophisticated investors	• **"Bad boy" issuers under Reg D.** Mandates that the SEC preclude certain "bad boy" issuers from raising capital in private markets using Regulation D (Dodd-Frank §926 — see §5.2.2) • **Asset-backed securities disclosures.** Mandates that the SEC establish additional disclosures on asset-backed securities (such as debt obligations that are collateralized by mortgages — CDOs), even when offered to sophisticated investors in private markets (Dodd-Frank §943)
Broker-dealer regulation	• **Fiduciary duties on broker-dealers.** Requires the SEC to consider subjecting broker-dealers (securities firms), when they give investment advice to clients, to the same fiduciary "customer first" standards that apply to investment advisers (Dodd-Frank §913) • **Securities arbitration.** Mandates the SEC to prohibit or limit mandatory predispute arbitration in broker-customer disputes (Dodd-Frank §921)

CHAPTER 12 Duty of Care and the Business Judgment Rule

The board of directors manages and oversees the corporation’s business and affairs. Judicial review of board decision-making and oversight is governed by the duty of care, which in turn is confined by the business judgment rule.

This chapter considers the articulated standards of care (§12.1) and their actual application under the deferential business judgment rule (§12.2). It then explains how the presumption that directors act in good faith with due care in the best interests of the corporation can be overcome (§12.3) and summarizes the available remedies (§12.4). Finally, the chapter describes the liability protections that directors have under exculpation provisions that arise in corporate charters and by statute (§12.5).

As you will discover in this chapter and those that follow, directors are insulated from liability in many ways. The business judgment rule and the exculpation provisions described in this chapter are two of the legs of a four-legged stool on which directors sit. The other two are the indemnification available to directors under corporate statutes and internal corporate processes (see §15.1) and directors’ and officers’ (D&O) liability insurance (see §15.2).

§12.1 STANDARDS OF CARE—ASPIRATIONAL GUIDANCE

In performing their functions, directors (and senior executives) are subject to both statutory and common-law standards of care. As you will discover, many of these standards are more *aspirational* than real. Because of the business judgment rule, directors rarely are held liable (or their decisions questioned) on the basis of directorial negligence. See §12.2 (below). In addition, many corporations have adopted exculpation clauses that further insulate directors from liability for their negligence. See §12.5 (below).

§12.1.1 Standards of Care

Statutory Standards

Many state statutes codify the standards for directorial behavior. Typical is MBCA §8.30 (as revised in 1998). Under the section, each *individual* director must discharge his duties in "good faith" and act "in a manner he reasonably believes to be in the best interests of the corporation." MBCA §8.30(a). In addition, members of the board must *collectively* become informed in performing their decision-making and oversight functions with "the care that a person in like position would reasonably believe appropriate under similar circumstances." MBCA §8.30(b) (replacing early, more stringent standard of "ordinarily prudent person"). Under many statutes, officers with discretionary authority are subject to similar standards. See MBCA §8.42(a).

Common-Law Standards

The articulated judicial standards follow much the same pattern as the statutory standards. The Delaware Supreme Court has stated that a party challenging a business decision must show the directors failed to act (1) in good faith, (2) in the honest belief that the action taken was in the best interest of the company, or (3) on an informed basis. *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984). In general, these judicial standards also apply to officers. See *Gantler v. Stephens,* 965 A.2d 695 (Del. 2009) (confirming that officers have same fiduciary duties as directors, though without the possibility of exculpation available to directors).

§12.1.2 Facets of Duty of Care

Each of the *standards of care* articulated in the statutes and by the courts identifies a facet of the *duty of care*.

Good Faith

The "good faith" standard requires that directors (1) be honest, (2) not have a conflict of interest, and (3) not approve (or condone) wrongful or illegal activity. See *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (holding that attitude of "we don't care about risks" breaches duty of good faith, a subset of the duty of loyalty). Fraudulent or self-interested action is subject to scrutiny under the director's duty of loyalty. See §13.2. Conscious disregard of corporate duties and intentional violations of positive law violate the director's duty of good faith. See §12.3.1 below.

Best Interests

The "best interests" standard involves the *substance* of director decision-making. The requirement that directors have a "reasonable belief" their decisions are in the corporation's best interests reflects both a subjective aspect (belief) and an objective one (reasonable). That is, directors must subjectively believe they are furthering the corporation's interests, and this belief must objectively be reasonable.

Under the "best interests" standard, a board decision must be related to furthering the corporation's interests. This standard embodies the "waste" standard, under which board action is invalid if it lacks any rational business purpose. See §12.3.2 below.

Informed Basis

The "informed basis" standard relates to the *process* of board decision-making and oversight. Directors must be informed in making decisions (see §12.3.3 below) to monitor and supervise corporate activities (see §12.3.4 below). In both capacities, directors must have at least minimal levels of skill and expertise. The "like position" formulation is meant to establish an objective standard that recognizes that "risk-taking decisions are central to the director's role." See Official Comment, MBCA §8.30 (replacing "ordinarily prudent person" formulation to avoid suggestion that benchmark is negligence). The "under similar circumstances" language has been understood to allow a court to take into account the complexity and urgency of the board's decision-making and oversight functions.

§12.1.3 Careless Directors Rarely Held Liable

The articulated care standards have a familiar ring—they sound in negligence. Just as there is liability for negligent driving that causes a traffic accident, you might assume that directorial liability regularly follows careless board decision-making that results in business failure. But in more than 150 years during which courts have articulated a directorial duty of care, there have been only a handful of cases in which directors and officers have been held liable for mere mismanagement uncomplicated by bad faith, illegality, fraud, or conflict of interest. What is really happening?

§12.2 BUSINESS JUDGMENT RULE

To understand a director's duty of care, one must understand the famous "business judgment rule." The rule, which is both procedural and substantive, reflects a judicial "hands off" philosophy—the golden rule of corporate law. As explained by the courts, the business judgment rule is a rebuttable presumption that directors in performing their functions are honest and well-meaning, and that their decisions are informed and rationally undertaken. In short, the business judgment rule presumes directors do not breach their duty of care.

Although the business judgment rule is not statutorily codified, courts have inferred its existence even in states with statutory care standards. As the Official Comment to MBCA §8.30 explains, the statutory standards of conduct for directors do "not try to codify the business judgment rule [which] continues to be developed by the courts." For this reason, some commentators have characterized the statutory standards as *aspirational*, their legal effect profoundly diluted by the business judgment rule.

§12.2.1 Operation of Business Judgment Rule

The business judgment rule shields *directors* from personal liability and insulates *board decisions* from judicial review—the latter sometimes referred to as the "business judgment doctrine." The business judgment rule also protects officers and their decisions. See ALI Principles §4.01.

The business rule has two aspects, one substantive and the other procedural. It describes the substantive *standard of review* to which director and board action should be submitted, and it creates a procedural *burden of proof* that requires the challenging party to rebut the presumption that directors act in good faith, in the best interests of the company, and with adequate information. Because of this burden and the procedural obstacles to overcoming the business judgment presumption (see §18.3, derivative suit procedures), claims that directors have breached their duty of care are often dismissed before trial.

§12.2.2 Justifications for the Business Judgment Presumption

The business judgment presumption has been justified on different grounds:

- **Encourages risk taking.** Shareholders expect the board to take business risks—the adage "nothing ventured, nothing gained" is at the core of why shareholders invest. Without the business judgment rule, directors might be too cautious. See *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049 (Del. Ch. 1996) (explaining that shareholders can absorb risk by investing in many companies).
- **Avoids judicial meddling.** Judges are not business experts. Further, derivative suit plaintiffs (and their lawyers) have incentives that may be at odds with the interests of the corporation and the body of shareholders. Corporate statutes reflect this notion and uniformly specify that corporate management is entrusted to the board of directors.
- **Encourages directors to serve.** Business people detest liability exposure. The business judgment rule encourages qualified persons to serve as directors and take business risks without fear of being judged in hindsight.

Some commentators have even suggested that the business judgment presumption should be absolute and corporate law should not enforce care standards. Mismanagement would be subject only to shareholder voting and the markets. If directors and officers perform poorly, the business will suffer and the corporation's stock price will fall. This will make it harder to raise capital. It will also make management vulnerable to shareholder activism, a proxy contest, or even a takeover. Eventually, poor management will be replaced or the corporation will go bankrupt. Moreover, if the managers develop a reputation for poor judgment, they will become less attractive in the executive job market.

§12.2.3 Reliance Corollary

An offshoot of the business judgment presumption entitles directors to rely on information and advice from other directors (including committees of the board), competent officers and employees, and outsider experts (such as lawyers and accountants). In addition, directors can rely on others to whom the board has delegated its decision-making or oversight functions. This *reliance corollary* is contained in many statutes and widely accepted by the courts. See MBCA §8.30(c)(e) (revised in 1998). Under some statutes, it also extends to officers. See MBCA §8.42(b).

Particularly in public corporations, directors must rely on information from others. They cannot be expected to learn and know about the full range of the corporation's business. But to claim reliance, directors must have become familiar with the information or advice and must reasonably have believed that it merited confidence. In addition, directors can rely on each other. The "reasonable care" standard of the MBCA recognizes that directors typically perform their oversight and decision-making functions collegially. This means that directors in becoming informed can rely on each other's experience and wisdom. See Official Comment, MBCA §8.30 ("If the observance of directors' conduct is called into question, courts will typically evaluate the conduct of the entire board").

Directors, however, cannot hide their heads in the sand and claim reliance if they have knowledge or suspicions that make reliance unwarranted. Official Comment, MBCA §8.30 (directors remain subject to general standards of care in judging reliability and competence of source of information). For example, a director who knows that management has overstated earnings cannot rely on an auditor's opinion that earnings are properly stated. In addition, management directors (with greater familiarity with the corporation's business or expertise in a particular matter) have a correspondingly greater duty to independently verify information. See *In re Emerging Communications, Inc. Shareholder Litigation*, 2004 WL 1305745 (Del. Ch. 2004) (holding director with financial expertise liable for not recognizing that price in “going private” transaction was unfair to shareholders). In general, though, the reliance corollary is more protective than the due diligence and reasonable care defenses available to directors charged with securities fraud. See §§5.3.2, 5.3.3.

§12.3 OVERCOMING BUSINESS JUDGMENT PRESUMPTION

When a board decision is challenged, courts place the burden on the challenger to overcome the business judgment presumption by proving either (1) fraud, bad faith, illegality, or a conflict of interest (lack of good faith, see §12.3.1 below); (2) the lack of a rational business purpose (waste, see §12.3.2 below); (3) failure to become informed in decision-making (gross negligence, see §12.3.3 below); or (4) failure to oversee the corporation’s activities (inattention, see §12.3.4 below).

The MBCA (as revised in 1998) largely tracks these judicial categories and specifies *standards of liability*. A director can become liable for

- action not in good faith
- a decision the director did not reasonably believe to be in the corporation’s best interests or as to which the director was not adequately informed
- conduct resulting from the director’s lack of objectivity or independence, unless the director proves he believed the conduct was in the corporation’s best interests
- a sustained failure to be informed in discharging the director’s oversight functions
- receipt of an improper financial benefit

MBCA §8.31(a) (challenger must also show director not covered by charter exculpation provision, see §12.5, or the statutory safe harbor for conflict-of-interest transactions, see §13.4).

§12.3.1 Lack of Good Faith

A director loses the presumption that he was acting in good faith—and thus the protection of the business judgment rule—if the challenger shows fraud, the conscious disregard of duties, the condoning of illegality, or a conflict of interest.

Fraud

A director who acts fraudulently is liable, and any action tainted by the fraud can be invalidated, regardless of fairness. For example, directors who mislead shareholders in connection with shareholder voting cannot claim protection under the business judgment rule. See §10.3. Likewise, directors who knowingly disseminate false or misleading information to public trading markets breach a duty of disclosure, a subset of their duties of loyalty and good faith. *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (holding that misinformation in communications to shareholders, even though not requesting shareholder action, violates "duty to deal with shareholders honestly"). In addition, a director who knowingly or recklessly misrepresents a material fact to the board on which the other directors rely to the corporation's detriment can be held liable under a tort deceit theory.

Conscious Disregard

Directors who "consciously disregard" their responsibilities are liable for violating their duty of good faith. *Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006). For example, directors can be liable for failing to call board meetings and acting as "stooges" for a controlling shareholder. *ATR-Kim Eng Financial Corp. v. Araneta,* 2006 WL 3783520 (Del. Ch. 2006). According to the Delaware courts, the duty of good faith is a subset of the duty of loyalty—thus, violating the duty of good faith cannot be exculpated. See §12.5 below.

As you can imagine, the financial crisis of 2008 has spawned the argument that directors in financial firms "consciously disregarded" subprime-mortgage risks, thus violating their duties of good faith. The argument, however, has fallen on mostly deaf judicial ears, given the absolving force of the business judgment rule. For example, when shareholders of Citigroup alleged that the firm's directors had failed to notice "red flags" brewing in the real estate and credit markets when they approved various investments in subprime loans, which eventually resulted in losses for the firm of $55 billion, the court dismissed the case and held that the alleged warning signals did not evidence conscious disregard by the directors. At most, said the court, “They evidence that the directors made bad business decisions.” *In re Citigroup Inc. Shareholder Deriv. Litig.,* 9643 A.2d 106 (Del. Ch. 2009) (pointing out that plaintiffs failed to allege board’s risk management committee, charged with monitoring credit risk, had ignored the subprime risks).

Illegality

Directors who intentionally approve or consciously disregard illegal behavior by the corporation violate their duty of good faith, even if the directors were informed and the behavior benefited the corporation. Older cases described the duty of directors to abide by corporate and noncorporate norms as the “duty of obedience,” a concept that continues to apply in nonprofit corporations.

For example, courts have said directors of for-profit corporations can be liable for approving

- bribery of state officials to protect an amusement park’s illegal (and profitable) Sunday operations. *Roth v. Robertson,* 118 N.Y.S. 351 (Sup. Ct. 1909).
- bribery of foreign government officials, even though the practice was widespread. *Gall v. Exxon,* 418 F. Supp. 508 (S.D.N.Y. 1976).
- the dismantling of corporate plants and equipment to discipline unruly employees in violation of labor laws. *Abrams v. Allen,* 74 N.E.2d 305 (N.Y. 1947).
- a business plan that created strong incentives for employees to commit Medicare and Medicaid fraud to attract medical referrals. *McCall v. Scott,* 239 F.3d 808 (6th Cir. 2001).

Fiduciary rules against corporate illegality, however, produce a conundrum. By making scofflaw directors liable as a matter of *corporate* law, not the positive law that prohibits the behavior, corporate fiduciary duties become a fountainhead for the enforcement of business regulation. On the one hand, there may be many instances when approving illegal behavior maximizes profits for the corporation. On the other hand, condoning known corporate illegality would be an affront to noncorporate norms and could undermine the legitimacy of the corporation.

Modern courts have recognized this tension. In *Miller v. AT&T,* 507 F.2d 759 (3d Cir. 1974), shareholders brought a derivative suit challenging AT&T's failure to collect a $1.5 million debt owed by the Democratic National Committee, a failure the plaintiffs said violated federal campaign finance laws. The Third Circuit accepted that under corporate norms the directors' business decision to forgive a debt is normally immune from attack. But the court held AT&T's failure to collect the DNC debt could be actionable if the directors had no "legitimate" business justification, aside from illegally currying political favor, for forgiving the debt. In other words, an illegal purpose alone cannot be a rational business purpose sufficient to trigger the business judgment rule.

Miller illustrates the curious result when corporate law is used to enforce noncorporate legal norms. One year after *Miller* was decided, the Supreme Court held that shareholders had no implied federal cause of action to enforce federal campaign spending laws. *Cort v. Ash*, 422 U.S. 66 (1975). Thus, shareholders were able to use *state fiduciary law* to obtain relief based on a federal statute that the Supreme Court interpreted precludes *federal relief* for shareholders.

Conflict of Interest

A director who is personally interested in a corporate action because he stands to receive a personal or financial benefit loses the business judgment presumption. This is true whether the director is an inside corporate employee or an outside independent director. The director's liability and the validity of the action depend on fairness standards that apply to conflict-of-interest transactions. See §13.3.

In addition, a director may become liable if a corporate action is approved because he is beholden to another person interested in the action. See MBCA §8.31(a)(2)(iii) (liability of director who lacks objectivity due to director's familial, financial, or business relation with interested person).

§12.3.2 Waste

The presumption of the business judgment rule also can be overcome if the action of the directors lacked a "rational" business purpose. The focus is on the merits of the board action or inaction—a substantive review of the challenged decision. When the challenger claims a transaction wholly lacks consideration, the cases often speak of “waste” or “spoliation” of corporate assets. The absence of a rational business purpose powerfully suggests bad faith—that is, a conflicting personal interest, illegality, or deception.

Rational Basis

How much of a business justification is sufficient? Under the *rational purpose test*, even board decisions that in hindsight seem patently unwise or imprudent are protected from review and the directors shielded from liability so long as the business judgment was not “improvident beyond explanation.” *Michelson v. Duncan,* 407 A.2d 121 (Del. 1979); see also ALI Principles §4.01(c) (comment) (“removed from the realm of reason”).

Only when the board approves a transaction in which the corporation receives no benefit—such as the issuance of stock without consideration or the use of corporate funds to discharge personal obligations — have courts found corporate waste. See Official Comment, MBCA §8.31(a)(2)(ii) (stating that it is a rare case where corporation’s best interest is “so removed from realm of reason” or director’s belief “so unreasonable as to fall outside bounds of sound discretion”). The theme is to protect good-faith board decisions from judicial second-guessing.

Illustrative Cases

If it can be said that the corporation received some fair benefit, the matter is entrusted to the directors’ judgment. As the following two famous cases illustrate, courts regularly forgive even glaring business folly:

- ***Shlensky v. Wrigley,*** 237 N.E.2d 776 (Ill. App. 1968). Before the Chicago Cubs joined the rest of the major leagues with night baseball games, Cubs’ shareholders challenged the board’s refusal to play night baseball at Wrigley Field. The shareholders alleged night baseball would increase profits and pointed to higher night attendance for the Chicago White Sox and other teams around the league. Phillip Wrigley, the Cubs’ majority shareholder and dominant member of the board, thought “baseball is a daytime sport.” The court dismissed the plaintiff’s complaint, speculating that night baseball might cause the neighborhood around Wrigley Field to deteriorate, resulting in a decline in attendance or a drop in Wrigley Field’s property value.

- ***Kamin v. American Express Co.,*** 383 N.Y.S.2d 807 (Sup. Ct. 1976). The directors of American Express faced the choice of liquidating a bad stock investment at the corporate level (taking a corporate tax deduction for the loss) or distributing the stock to the shareholders as a special dividend (a taxable event for the shareholders). Although the choice seemed obvious, the board opted for the stock dividend, and shareholders sued. The directors explained they were concerned liquidation at the company level would have adversely impacted the company’s *accounting* net income figures. The court found the concern sufficient. That is, the court accepted that appearances could be more important than actual cash effects.

Safety-Valve Cases

Are actions by the board ever irrational? Only a small handful of cases have found good-faith board action so imprudent as to fall outside the business judgment presumption. But under closer inspection, even these few cases where courts have found waste may not reflect disinterested misjudgment, but rather judicial use of care standards when a conflict of interest could be inferred, but not proved—that is, “safety valve” cases.

Consider *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940), the most famous of these cases. The court imposed liability on the directors of Guaranty Trust, a bank affiliate of J. P. Morgan & Company, for approving stock repurchase agreements (repos) in the tenuous stock market after the 1929 crash. Under the repos, Allegheny Corp. sold Guaranty Trust convertible 5.5 percent debentures at $100 par at a below-market price. In return for this discount, Guaranty Trust gave an option to Allegheny to repurchase the debentures at par in six months—in effect, a call option. Although Guaranty Trust could have sold the bonds immediately, realizing the purchase discount, it took a gamble that prices would rise and it could sell higher. When prices continued to fall and Allegheny failed to exercise its option (to repurchase), Guaranty Trust was left holding the bonds. It had bought the bonds at a favorable price and guessed wrong that the panic of 1930 had reached bottom.

The court faulted the directors for approving a transaction “so improvident, so risky, so unusual and unnecessary to be contrary to fundamental conceptions of prudent banking practice”—precisely the kind of second-guessing precluded by the business judgment rule. Surely the Guaranty Trust directors, among the most experienced risk managers in banking, had not been inattentive to the repos’ risk.

So what was really happening in *Litwin v. Allen*? Many commentators have explained the case as imposing a higher duty on directors of financial institutions, who frequently were defendants before the era of federal deposit insurance. But there may be another explanation. Allegheny was the holding company for the Van Sweringen empire in which J. P. Morgan & Company was deeply involved. Morgan’s interest in buttressing Allegheny’s sagging fortunes was surely not lost on the Guaranty Trust directors. Although the court agreed that there was no showing of conflict of interest, the court’s use of a heightened care standard (a “safety valve”) overcame this lack of proof.

§12.3.3 Gross Negligence

To claim the business judgment presumption in a decision-making context, directors must make reasonable efforts to inform themselves in making the decision. The focus is on procedure, and the courts assume diligent board deliberations ensure rational board action. Liability is generally based on “concepts of gross negligence.” Compare MBCA §8.31(a)(2)(ii)(B) (director liable if not informed about decision “to an extent the director reasonably believed appropriate in the circumstances”).

Trans Union

When are directors not adequately informed? The most famous and controversial answer comes from *Smith v. Van Gorkom* (*Trans Union*), 488 A.2d 858 (Del. 1985). In a 3-2 decision, the Delaware Supreme Court held the directors of Trans Union Corporation could be personally liable for not informing themselves adequately when they approved the sale of the company in a negotiated merger.

The case involved a friendly cash-out merger. The sequence of events, described in great detail in the court’s opinion, paints the picture of a CEO (Van Gorkom) who initiated, negotiated, and promoted a merger agreement whose terms may have favored the acquirer (Pritzker). Shareholders brought a class action challenging the board’s failure to become sufficiently informed.

The court recited a litany of errors by a board composed of five management directors and five eminently qualified outside directors. According to the court, the directors had failed to inquire into Van Gorkom's role in setting the merger's terms; failed to review the merger documents; had not inquired into the fairness of the $55 price and the value of the company's significant, but unused, investment tax credits; accepted without inquiry the view of the company's chief financial officer (Romans) that the $55 price was within a fair range; had not sought an outside opinion from an investment banker on the fairness of the $55 price; and acted at a two-hour meeting without prior notice and without there being an emergency.

In response, the directors asserted they had been entitled to rely on Van Gorkom's oral presentation outlining the merger terms and on Romans's opinion. But the court held no reliance was warranted because Van Gorkom had not read the merger documents before the meeting and did not explain that he, not Pritzker, suggested the $55 price. In addition, the court pointed out that the directors had never questioned Romans about the basis for his opinion and had not asked about the views of senior management, who had strenuously objected to aspects of the agreement (including the price).

The *Trans Union* court rejected a number of arguments that normally would have carried the day under the business judgment rule. Consider the rational justifications given for the merger: the $55 merger price both reflected a significant premium over the then-$38 market price and was within internally calculated leveraged buyout ranges. The directors, who had significant business expertise and background knowledge of Trans Union's business, had no reason to doubt Van Gorkom's assertion of the merger's fairness. The board's approval was later conditioned on a "test market" during which other offers could be solicited. The board was operating under the time pressure of a Pritzker deadline. Outside counsel had advised the directors they might be sued for turning away an attractive offer.

What if the board had asked, read, and heard what it was charged with having failed? At most, the directors would have learned that Van Gorkom had negotiated on his own initiative a deal with a personal and business acquaintance, had proffered a price during the negotiations at the low end of a credible range of fair value, and had agreed to a merger with some disadvantageous terms that senior management objected to. Even if the directors had been fully informed, as eventually happened at a later meeting when they reapproved the merger, there is little to suggest they might have extracted a better deal. The court's second-guessing of boardroom procedures has been harshly criticized.

Meaning of *Trans Union*

What are the *Trans Union* lessons? The case is among the few holding directors liable for a rational decision as to which there were no allegations of bad faith or self-dealing. Commentators have suggested various explanations:

- **Delaware reassertion.** The Delaware Supreme Court was giving teeth to Delaware fiduciary law, which during the 1970s and early 1980s had come under heavy criticism for being too lax. The Trans Union board's decisional failures provided a convenient target for the court to assert itself. Its emphasis on board processes also put a premium on good lawyering, presumably by the Delaware corporate bar.
- **Fast shuffle.** The case had self-dealing overtones. Van Gorkom was reaching retirement age, and the merger allowed him to realize an immediate $1.5 million increase in the value of his shareholding. As the *Trans Union* dissent pointed out, the majority seemed to believe the directors had been victims of a Van Gorkom—Pritzker "fast shuffle." In subsequent cases, the Delaware courts have readily faulted directors who approve transactions in which managers extract bribes from the acquiror as a condition for the transaction. See *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243 (Del. 1999) (finding breach of fiduciary duties when directors approved merger conditioned on CEO receiving special payments from acquiror).
- **End-period event.** A board's consideration of a cash-out merger deserves heightened review. When shareholders are cashed out in a merger, a faulty board decision cannot be corrected through the operation of product, securities, and control markets. For this reason, mergers and other "end period" decisions should be subject to more stringent review than typical operational decisions. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (*Cede II*) (finding care breach by directors who failed to inquire about negotiation and terms of merger); see also *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2005) (explaining *Trans Union* as "sale of entire company" for which board approval required by statute).
- **Antitakeover implications.** Perhaps *Trans Union* was meant to *promote*

> board discretion in future takeover cases. After the case, directors who receive an unsolicited offer for their company can put off the unwanted buyer on the ground that Delaware law requires them to take their time to first become fully informed.

Despite its importance to corporate fiduciary law, the *Trans Union* puzzle has yet to be fully solved.

§12.3.4 Inattention

Directors have oversight functions that go beyond making decisions at board meetings. Particularly in public corporations, directors are expected to monitor management, to whom is delegated day-to-day business. To carry out their duties, directors are presumed to have unrestricted access to all corporate information. *Kortum v. Webasto Sunroofs, Inc.*, 769 A.2d 113 (Del. Ch. 2000) (corporation has burden to permit director's inspection of corporate information related to directorial role). The monitoring duty requires directors to inquire into managers' competence and loyalty. A director cannot passively sit by, for example, if she knows that the corporation's treasurer is embezzling money. Judicial review has varied depending on whether the director is inattentive to *mismanagement* or to *management abuse.*

Inattention to Mismanagement

Courts have been reluctant to hold directors liable for inattention to mismanagement. A classic case is *Barnes v. Andrews,* 298 F. 614 (S.D.N.Y. 1924) (Learned Hand, J.). There a director—whose "only attention to the affairs of the company consisted of talks with the president [who was a friend] as they met from time to time"—was sued after the business failed because of the president's poor business judgment. Learned Hand concluded the passive director, though he had technically breached his duty of care, could not be liable because nothing indicated he could have prevented the business failure. Learned Hand pointed out that it would be impossible to know if the director could have saved the business. Even if the inquiry were possible, the business judgment rule teaches it should not be conducted by judges.

Nonetheless, a few cases (perhaps confusedly) have imposed liability for mere inattention. See *Hoye v. Meek*, 795 F.2d 893 (10th Cir. 1986) (finding that bank director, whose family controlled the bank, violated duty of care under Oklahoma statute's "ordinarily prudent director" standard by not attending board meetings and not monitoring risky investment decisions of his son).

Inattention to Management Abuse

Courts have been less forgiving when a director fails to supervise management defalcations and deceit. In fact, most cases that impose liability on directors for care breaches—older bank cases and newer S&L cases—have involved directors who turned a blind eye to managers with their hands in the corporate till. Liability hinges on whether the director knew or had reason to know of the management abuse. Courts more readily infer knowledge of abuse in the case of management directors.

A modern (though not necessarily illustrative) example is *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981). Mrs. Pritchard was the widow of the founder of Pritchard & Baird, a closely held reinsurance brokerage business. After her husband's death she became a director, but was inactive and knew virtually nothing about the business. She never read the firm's annual financial statements, which revealed that her sons were taking client funds in the guise of "shareholder loans." The court held her liable for failing to become informed and make inquiries and inferred that Mrs. Pritchard's laxity proximately caused the losses to the corporation. She could have brought her sons' illegal misappropriations to the attention of insurance officials.

Although *United Jersey Bank* seems to imply directors must inquire whenever management defalcation is possible, most modern cases do not go so far. Instead, inattentive directors are liable only if circumstances indicate they actually knew of or suspected management diversion. *United Jersey Bank* can be explained by its peculiar facts. The suit was brought by a bankruptcy trustee against the widow and her two sons, the only directors. After her husband died, Mrs. Pritchard had become listless and had started to drink heavily. During the proceedings she died, and the suit proceeded against her estate, whose beneficiaries were presumably her sons. The desire to add the estate's assets to the bankruptcy pool may explain the court's duty of care analysis.

Recent Delaware courts have used the duty of good faith to impose liability on directors who fail to adequately monitor management misbehavior. By couching the analysis in terms of lack of “good faith,” rather than lack of “care,” director liability is not subject to exculpation under Del. GCL §102(b)(7) (see §12.5 below).

Monitoring Corporate Compliance

The requirement that directors know of or suspect management abuse extends to the duty of directors to monitor corporate illegality. In *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), the court held that the business judgment rule shields directors who had failed to detect antitrust violations (criminal bid-rigging) by mid-level executives. According to the court, unless the director knew of or suspected the bid-rigging, they were not obligated to install a monitoring system. The MBCA *standards of conduct* regarding directorial oversight functions also reflect this view. In matters of legal compliance, “the director may depend upon the presumption of regularity, absent knowledge or notice to the contrary.” Official Comment, MBCA §8.30(b).

More recent Delaware cases have held, however, that a board has a duty to install corporate monitoring and reporting systems to detect accounting irregularities and illegal behavior—even in the absence of “red flags.” See *In re Caremark Int’l Inc.*, 698 A.2d 959 (Del. Ch. 1996) (approving settlement of derivative suit challenging board’s failure to create monitoring system, which allegedly would have revealed illegal kickbacks by company to get Medicare/Medicaid patients). Given the greater activism expected of corporate directors and the increased penalties under the federal sentencing guidelines for crimes committed by organizations without compliance programs, boards act at their peril by not instituting monitoring systems to assure accurate information about the corporation’s compliance with law, financial reporting, and business performance.

In 2006 the Delaware Supreme Court clarified the nature of a *Caremark* claim and explained that director oversight is subject to review under the duty of good faith, which the court characterized as a subset of the duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). The case involved a derivative suit brought by shareholders against directors of AmSouth Bancorporation seeking personal liability for their failure to implement a monitoring system required by the federal Bank Secrecy Act. The shareholders claimed that better oversight would have revealed that bank employees had unwittingly allowed bank accounts to be used by a couple scoundrels running a Ponzi scheme (where returns to early investors are paid from investments by later investors). Federal banking authorities found that AmSouth's monitoring program was "materially deficient" and imposed record-setting fines and penalties of $50 million.

Nonetheless, the court held that the directors had not engaged in a *deliberate* failure to exercise oversight (or a *conscious disregard* of their responsibilities). The court found that the bank had implemented a monitoring system that was designed to present information on compliance with the Bank Secrecy Act requirements. That the system failed, according to the court, was not enough to establish "a sustained or systematic failure of the board to exercise oversight." The court pointed out that subjecting directors to personal liability for employee failures—that is, making out a *Caremark* claim—is "possibly the most difficult theory" in corporate law.

Despite the difficulties of bringing a *Caremark* claim, the Delaware courts have lately been receptive to claims that directors failed in their duty of oversight, specifically as it pertains to a corporation's overseas operations. In 2013, for example, the Delaware chancery court permitted *Caremark* claims to proceed in three separate cases involving challenges to board oversight of overseas operations, pointing out that directors who fail to act in the face of a known duty to act (namely, to ensure accurate accounting of business transactions) demonstrate a conscious disregard for their responsibilities and thus breach their duty of loyalty. See, e.g., *Rich v. Chong*, 2013 WL 3353965 (Del. Ch. 2013) (finding corporation's overseas compliance systems "woefully inadequate" by, among other things, carving out retail segment from general ledger, not detecting multiple unrecorded payments and accounts receivable, and incorrectly recording inventory movements).

§12.3.5 Oversight under Sarbanes-Oxley and Dodd-Frank

In response to Enron and other accounting scandals, the Sarbanes-Oxley Act of 2002 (see § 11.5.1) mandated new corporate oversight mechanisms—in the process federalizing large swaths of corporate behavior previously within the board's discretion under the business judgment rule. The Dodd-Frank Act of 2010 (see § 11.5.2) modified some of the Sarbanes-Oxley requirements.

Certification of SEC Filings and Internal Controls

As commanded by Sarbanes-Oxley, the SEC adopted rules requiring corporate officers of "reporting companies" (see §21.2.2) to certify the annual and quarterly reports filed with the SEC. Sarbanes-Oxley §302. Under SEC rules, the CEO and CFO each must certify that he reviewed the report and, based on his knowledge, that (1) it does not contain any material statements that are false or misleading, and (2) it "fairly presents" the financial condition and results of operation of the company—regardless of formal compliance with generally accepted accounting principles (GAAP). Exchange Act Rules 13a-14, 15d-14.

In addition, the officers must certify that they are responsible for establishing and maintaining "disclosure controls and procedures" that ensure material information is made known to them and that these internal controls were evaluated before making the report. Sarbanes-Oxley §302. If there are any significant deficiencies or changes in the internal controls or any fraud by those who operate them, the certifying officers must disclose this to the company's auditors and the board's audit committee. Exchange Act Rules 13a-15, 15d-15, 15d-14.

To impress upon certifying officers the gravity of these tasks, Sarbanes-Oxley enhanced the criminal sanctions for certifications that are knowingly or willfully false. Sarbanes-Oxley §906, 18 U.S.C. §1350 (requiring CEO and CFO to certify that periodic report "fully complies" with Exchange Act and "fairly presents" material financial condition and results). Knowing violations carry penalties up to $1 million and 10 years' imprisonment and willful violations up to $5 million and 20 years' imprisonment.

Internal Controls

In a significant expansion into state law, Sarbanes-Oxley increased the scope (and burden) of internal controls on reporting companies beyond financial accountability. Sarbanes-Oxley §404. Internal controls are, as commanded by Sarbanes-Oxley, the SEC adopted rules requiring reporting companies to include in their annual report a statement of management's responsibility over internal controls, a statement of how those controls were evaluated and an assessment of their effectiveness (or weaknesses) over the past year, and a statement that the company's auditors attested to management's assessment. Items 307 and 308, Reg. S-K; Exchange Act Rel. No. 47,986 (2003).

From the beginning, the internal controls requirement was controversial. It was argued that such controls were not cost justified—particularly for smaller public companies. Responding to these arguments, the SEC permitted smaller public companies (with a market cap of less than $75 million) to delay until 2008 their implementation of internal controls and also exempted such companies from the auditor attestation requirement through 2010. In the Dodd-Frank Act of 2010, Congress made the attestation exemption permanent. Dodd-Frank §989G (adding §404(c) to Sarbanes-Oxley Act); Exchange Act Rel. No. 62,914 (2010). Thus, smaller public companies are only subject to the requirement that management certify the company's internal controls.

Whistleblower Protection

Sarbanes-Oxley gave whistleblowers in public companies special protections. The audit committee of listed companies must establish procedures to receive anonymous submissions from employees on "questionable accounting or auditing matters." Sarbanes-Oxley §301, Exchange Act §10A(m). In addition, whistleblowers in public companies who report securities fraud to a federal agency, Congress, or a company supervisor cannot be retaliated against. Sarbanes-Oxley §806; 18 U.S.C. §1514A (public company and specified individuals cannot "discharge, demote, suspend, threaten, harass, or in any other manner discriminate" because of lawful reporting). If there is retaliation, the whistleblower can file a complaint with the U.S. Department of Labor within 90 days. OSHA investigates the complaint, and civil penalties (back pay and attorney fees) can be imposed by the agency or in a court action against retaliating individuals and the company. Retaliation can also result in criminal penalties, including fines and prison terms up to ten years. Sarbanes-Oxley §1107; 18 U.S.C. §1513(e).

Enforcement of the Sarbanes-Oxley whistleblower provisions, however, has been mixed. In response, Dodd-Frank increased whistleblower protection by, among other things, providing whistleblower plaintiffs who claim retaliation a jury-trial right, double pay and reinstatement, as well as doubling the statute of limitations for whistleblower claims. Dodd-Frank §922 (adding new Exchange Act §21F). Dodd-Frank also sought to encourage whistleblowers by providing a monetary reward of between 10—30 percent of amounts recovered by the SEC in an enforcement action against the offending issuer, provided the recovery is above $1 million. Exchange Act

Regulation 21F (implementing whistleblower reward program, which also creates incentives for employees to report company abuses internally; whistleblowers criminally convicted are not eligible for reward). See Exchange Act Rel. No. 54,545 (2011).

Audit Committee Regulation

Sarbanes-Oxley mandated that U.S. stock exchanges adopt standards on the composition and functions of the audit committee of listed companies. Sarbanes-Oxley §301, Exchange Act §10A(m). Under these standards, the audit committee of listed companies (including foreign issuers and small business issuers) must be composed entirely of independent directors, as defined by the SEC. In addition, companies must disclose whether at least one member of the committee is a financial expert. Sarbanes-Oxley §407, Reg. S-K, Item 401 (defining "audit committee financial expert" as one with significant auditing, accounting, financial, or comparable experience).

The audit committee must be responsible for appointing, compensating, and overseeing the company's independent audit firm—a curtailment of the power of the full board and shareholders over outside accountants. The audit committee (not the board) must have the authority to hire independent counsel and other advisors, their fees to be paid by the listed company. Rule 10A-3; Exchange Act Rel. No. 47,654 (2003).

Code of Ethics

Sarbanes-Oxley commanded the SEC to require reporting companies to disclose whether they have adopted a code of ethics applicable to their top financial and accounting officers—and if not, explain why. Sarbanes-Oxley §406; Item 406, Reg. S-K. Any changes or waivers of the ethics code for such officers must be promptly disclosed on Form 8-K. Exchange Act Rel. No. 47,235 (2003) (see §21.2.2).

"Up the Ladder" Reporting by Lawyers

As commanded by Sarbanes-Oxley, the SEC promulgated a rule requiring lawyers "appearing and practicing before" the SEC to report evidence of a material violation of securities law or breach of fiduciary duty (or similar violation) to the company's general counsel or CEO. Sarbanes-Oxley §307; 17 C.F.R. §205. Failing an appropriate response, the lawyer must then report to the company's audit committee, another committee composed exclusively of outside directors, or the full board. Although not free from doubt, this "up the ladder" reporting obligation applies both to inside and outside lawyers who represent the issuer before the SEC or advise on securities matters—whether the issuer is a reporting company or going public.

A securities lawyer's failure to report "up the ladder" can be the basis for SEC discipline and sanctions; no private right of action is created. This federalization of lawyer professional duties reminds corporate/securities lawyers that they work for the corporation and its shareholders, not corporate executives.

§12.4 REMEDIES FOR BREACHING THE DUTY OF CARE

If a challenger overcomes the business judgment presumption and shows the board's decision was uninformed or lacked a rational basis, any director who participated in the decision is liable for breaching a duty of care. The next question becomes what remedies the challenger can expect.

§12.4.1 Personal Liability of Directors

If board action violates the duty of care, courts have held that each director who voted for the action, acquiesced in it, or failed to object to it becomes *jointly and severally* liable for all damage that the decision proximately caused the corporation. Under most state statutes, a director who attends a meeting at which an action is approved is presumed to have agreed to the action, unless the minutes of the meeting reflect the director's dissent or abstention. MBCA §8.24(d). Some statutes allow a director who has not voted for the action to register her dissent or abstention by delivering written notice at or immediately after the meeting. MBCA §8.24(d).

Not every care breach, however, creates liability for damages. Some courts require the challenger to show the director's action (or inaction) proximately caused damage to the corporation. *Barnes v. Andrews,* 298 F. 614 (S.D.N.Y. 1924). Proximate cause is important in oversight cases. When directors disregard management abuse, courts readily find proximate cause. But when directors are inattentive to mere mismanagement, courts are less willing to make the causal finding. It would be anomalous to impose liability on a director for being inattentive to business mistakes that are themselves protected by the business judgment rule.

The MBCA's liability provisions state that directors who breach their care duties are liable in damages only if the violation proximately caused harm to the corporation or shareholders. MBCA §8.31(b)(1). Nonetheless, in a Delaware case involving uninformed board decision-making, the court refused to make proximate cause an element of the plaintiff's case and shifted the burden to the careless defendants to prove the challenged transaction's "entire fairness." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (*Cede II*). Under this approach, lack of proximate cause becomes an affirmative defense.

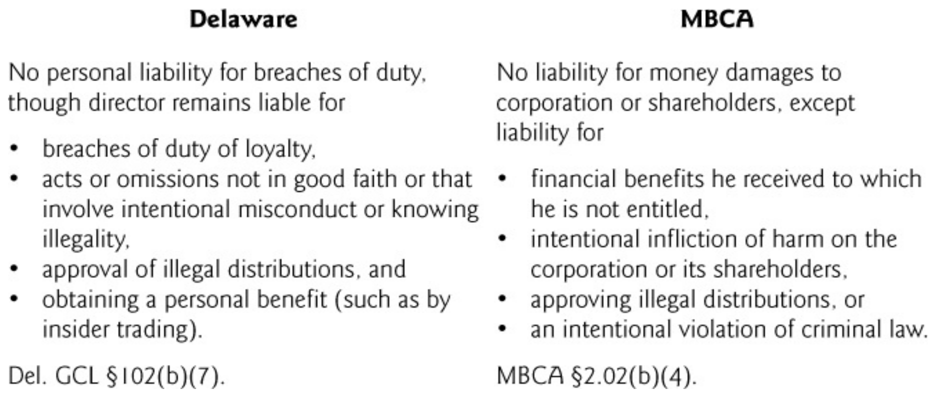
§12.4.2 Enjoining Flawed Decision

Courts can also enjoin or rescind board action unprotected by the business judgment doctrine. Some commentators have suggested that it should be easier to enjoin corporate action than to impose personal liability. Courts, nonetheless, have not explicitly distinguished between cases to impose personal liability and to enjoin board action.

§12.5 EXCULPATION OF DIRECTORS' CARE FAILURES

§12.5.1 Exculpation Statutes

After *Trans Union* a perception grew that service as a corporate director had become more risky. During the late 1980s, insurance premiums for D&O insurance increased, and there were reports of directors who declined to serve for fear of liability exposure. In response, Delaware and most other states enacted exculpation statutes that authorize charter amendments shielding directors from personal liability for breaching their duty of care—a "raincoat" protecting directors from liability.



Delaware	MBCA
No personal liability for breaches of duty, though director remains liable for	No liability for money damages to corporation or shareholders, except liability for
• breaches of duty of loyalty, • acts or omissions not in good faith or that involve intentional misconduct or knowing illegality, • approval of illegal distributions, and • obtaining a personal benefit (such as by insider trading).	• financial benefits he received to which he is not entitled, • intentional infliction of harm on the corporation or its shareholders, • approving illegal distributions, or • an intentional violation of criminal law.
Del. GCL §102(b)(7).	MBCA §2.02(b)(4).

The exculpation provision can be included in the articles of a newly formed corporation or added by amendment with board and shareholder approval. None of the exculpation statutes affects the granting of equitable relief.

Note on Exculpation of Officers

One important thing to notice is that the statutes provide for exculpation only of directors, not officers—on the theory that the promise of exculpation is necessary to attract *directors* to the board and encourage their good-faith decision-making. Thus, officers are fully subject to the duty of care, their gross negligence not exculpable. See *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (confirming that officers are subject to same fiduciary duties as directors).

This means it is possible that persons who serve both as directors and officers of a corporation may be exculpated for their actions as directors, while remaining subject to liability for actions in their capacity as officers. See *Chen v. Howard-Anderson*, 87 A.3d 648 (Del. Ch. 2014) (finding directors exculpated for preferring outside bidder, though inside directors who served as officers subject to claims they preferred bidder to benefit themselves).

§12.5.2 Effect of Exculpation

Exculpation provisions have been the subject of judicial interpretation, particularly in Delaware. Early cases focused on the meaning of the statutory exceptions. For example, exculpation provisions have been interpreted not to cover violations of disclosure duties, a theory of liability often used whenever a transaction involves shareholder voting. See *Zirn v. VLI Corp.,* 621 A.2d 773 (Del. 1993) ("equitable fraud" in a third-party merger). Left open are questions about the lines between care, loyalty, and good-faith violations. For example, when directors are sued for care violations, the real reason for liability (such as tacit approval of a managerial conflict of interest) suggests the statutory exceptions would not exculpate the directors from money damages. For example, if the Trans Union directors consciously acceded to Van Gorkom's "fast shuffle," their failure to become informed may have constituted "action not in good faith"—unprotected under a Delaware §102(b)(7) charter provision.

The Delaware courts have sought to explain the procedural effect of an exculpation provision in the corporate charter. In one case, the court held that plaintiffs challenging director conduct have the burden to allege well-pleaded facts that the conduct falls within the exceptions of the Delaware statute. *Malpiede v. Townson,* 780 A.2d 1073 (Del. 2001). But in another case, the court concluded that an exculpation provision is "in the nature of an affirmative defense," requiring directors to establish each of its elements, including good faith in a parent-subsidiary merger. *Emerald Partners v. Berlin,* 726 A.2d 1215 (Del. 1999) (*Emerald I*). Then in a second appeal in the same case, the court decided that when claims of care violations are mixed with claims of disloyalty and lack of good faith, the question of exculpation arises only *after* a finding that the transaction was not entirely fair. Only then can the trial court decide whether the unfairness arose from behavior challenged in the exculpated care claims or the nonexculpated loyalty or bad faith claims. *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) (*Emerald II*).

Notice the effect of this procedural jumble. When a plaintiff adequately pleads conduct that falls within the statutory exceptions, directors charged with *both* care and loyalty or good-faith violations must go through a full trial on both claims before interposing their affirmative exculpation defense—which once presented presumably wipes clean any damages claims based only on care violations.

§12.5.3 Evaluation of Exculpation

Exculpation statutes and the charter provisions they have spawned raise troublesome questions. Is it good policy to allow directors to escape their care responsibilities? Does shareholder approval of an exculpation provision, particularly through proxy voting in a public corporation, provide meaningful assurances that shareholder interests are furthered?

One important study strongly suggests the shareholders (in stock trading markets) think exculpation statutes eviscerate care liability and disserve shareholders. The study found that share prices of companies incorporated in Delaware fell 2.96 percent compared to companies incorporated in other jurisdictions over the months surrounding the effective date of the Delaware "charter option" statute. The study also found that when particular Delaware corporations adopted a charter limitation their stock price experienced a second (somewhat smaller) drop. Bradley & Schiapani, *The Relevance of the Duty of Care Standard in Corporate Governance,* 75 Iowa L. Rev. 1 (1989).

Examples

1. EnTrade, a publicly traded company incorporated in an MBCA jurisdiction, is an energy trading firm that creates a marketplace for energy producers, carriers, and users. Offering an online system for buying and selling electricity and natural gas, along with energy transportation services, EnTrade is the largest energy broker in the country. In addition, to make participation in EnTrade's market more attractive, the company offers its customers "risk management" products that allow customers to buy financial contracts to protect themselves against price fluctuations. For example, an electric utility in California can use EnTrade to purchase electric power from a low-price industrial cogenerator in Louisiana, along with transmission services to get the power to California and a "hedging" contract that protects the utility if the market price falls. It is a brilliant business model that has won EnTrade recognition as the most innovative U.S. company by *Fortune Magazine*—for five years running. (These examples, drawn loosely from SEC filings of Enron Corp. and the February 2002 "Report of Investigation" by a special investigative committee of the Enron board, are wholly fictitious. For an excellent description and analysis of the Enron debacle, see William Bratton, *Enron and the Dark Side of Shareholder Value,* 76 Tul. L. Rev. 1275 (2002).)

   The success of EnTrade has attracted competitors offering similar energy trading systems, often at less cost. Even as EnTrade's revenues continue to grow impressively, its net income has grown more slowly—EnTrade's margins are shrinking. In response, EnTrade's management proposes a bold strategy. The company will expand its energy trading operations to other countries and begin to trade nonenergy commodities, as well. Although the company has no experience in these areas, the hope is that techniques used for energy trading in the United States can be used in other countries and in nonenergy markets such as pulp and paper, steel, and even telecommunications bandwidth. After some deliberations, the board approves the expansion plan.

a. Sherron, an EnTrade shareholder, learns of the board's approval of the expansion and thinks it is a huge business mistake. Sherron wants to stop the expansion in court. How and on what theory?

b. The company spends $1.2 billion on a fiber optic network to run the company's expanded trading system. Sherron believes the money has been misspent and wants the directors to reimburse the corporation. On what theory?

c. Despite the state-of-the-art computer network and 1,700 new employees, the expansion project shows no signs of profitability. Six months after the expansion plan is put into effect, the company's stock has lost 40 percent of its value. Without knowing more, what chance does Sherron have of succeeding on either of these two claims?

2. As Sherron delves into the board's approval of EnTrade's expansion plan, she learns more. Which will support her challenge of the plan?

   a. Online trading of telecommunications bandwidth (the biggest aspect of EnTrade's expansion plan) is not a new idea. Other companies have tried it and have uniformly discovered that the telecommunications market is not ready. In fact, finding that acting as a bandwidth broker is hugely unprofitable, these other companies have all withdrawn from the business.

   b. When the EnTrade board met to approve the expansion plans, the company's CEO, Acosta, failed to tell the directors that telecommunications companies (some with more resources than EnTrade) had considered the idea of creating a bandwidth brokerage service and rejected it.

c. Acosta told the board that 40 percent of telecommunications companies in marketing surveys said they were interested in the concept of a bandwidth market. He failed to mention that 50 percent of the respondents who reviewed an online trading prototype said it did not fit their needs and they would never use it.

d. Acosta owns a majority interest in a company called Mastico which will offer consulting services in EnTrade’s bandwidth trading operations. Acosta reveals his interest in Mastico, and the board members are aware of EnTrade’s plans to hire Mastico as part of the company’s expansion into bandwidth trading.

e. Deere & Carbo, the company’s outside lawyers, opined that the Mastico deal is fair to EnTrade, even though the lawyers failed to question or review the way in which EnTrade has guaranteed Mastico’s obligations.

3. Problems for EnTrade mount. A key to EnTrade’s online energy trading is its offering of risk management to traders through “hedge” contracts. Under these contracts EnTrade acts as principal, guaranteeing its online customers protection against the risks of shifting commodity prices, interest rates, foreign currencies, and even stock prices. Although EnTrade has assured its shareholders that it has instituted its own risk management programs to protect the company from exposure to sudden price swings, EnTrade is not well hedged and lacks adequate reserves. The Commodity Futures Trading Commission (CFTC), the federal regulator of commodities markets, investigates and threatens to sue EnTrade for “engaging in the business of commodity futures trading” without satisfying a host of regulations, including financial standards applicable to a “designated commodities futures market.” At the next board meeting, CEO Acosta reports on the CFTC’s position. Experienced, outside legal counsel opines there is a good chance a court would reverse the CFTC’s jurisdictional grab, and the board authorizes a lawsuit against the CFTC.

    a. The EnTrade board approves further steps in the company’s expansion plan, including more aggressive, longer-term risk management programs that put the company at even greater risk if energy prices fall. The board does not seek authorization from the CFTC. If Sherron sues to enjoin the company’s risk management program, is the board's decision to continue it protected by the business judgment rule?

b. The CFTC obtains a court injunction against EnTrade's continuing to offer risk management products, and the court imposes a substantial fine against EnTrade for marketing commodities futures without CFTC approval. Are the EnTrade directors liable to the corporation for approving the illegal conduct?

c. It turns out EnTrade's risk management practices were more aggressive than authorized by the board. EnTrade traders routinely understated the company's risk exposure by failing to "mark to market" their hedge contracts. This means the company's financial disclosure seriously misstates the company's contingent liabilities. The board, however, had never instituted a reporting system to keep track of the value (and exposure) of the company's proprietary risk management products. Are the EnTrade directors liable for not monitoring the company's risk management business?

4. The courts uphold the CFTC assertion of jurisdiction over EnTrade's risk management business, and Congress does not provide an exemption. All told, the company loses $150 million in business expenses, litigation costs, and regulatory penalties in its bid to be an unregulated commodity futures market. (This amount does not include the large losses the company eventually experiences when energy prices fall and it is forced to close its many "unhedged" positions.) Shareholders bring a derivative suit against the EnTrade board for failing to become adequately informed about the legality of the company's risk management business.

   a. The minutes of the meeting at which the board decided to continue in the risk management business despite the CFTC's position reveal the following: Director Nessum was not present; Director Rowland recused herself from the decision; Director Adams abstained from voting; and the remaining six directors voted to approve continuing the business. Which directors can be held liable?

   b. Director Rowland, who recused herself at the meeting, now claims that even if she had voted against the decision her dissent would not have changed the outcome. Does this affect her liability?

   c. At the time of the board's decision, the EnTrade articles exculpated directors from personal liability to the corporation "to the full extent permitted by law." Does this provision insulate the EnTrade directors from liability?

d. Assuming the directors are not exculpated, are they liable for all of EnTrade's risk management losses?

5. EnTrade also owns natural gas utilities and pipelines—old-fashioned "hard assets." In addition to its aggressive risk management practices, the company uses its hard assets to create cash—adding even more luster to its soaring stock price. How? EnTrade moves hard assets worth billions into affiliated entities, many of them majority owned by EnTrade and most of them financed by borrowings from outside lenders (such as Citigroup and JP Morgan Chase) that take EnTrade stock as loan collateral. This means that EnTrade has leveraged its own stock to create cash in the affiliates, which then comes pouring into EnTrade. Only if EnTrade's stock price falls below preset thresholds will there be a problem. But as the stock market becomes concerned about EnTrade's investments and the risks in its core energy trading business, its stock price falls—triggering the collateral obligations that EnTrade owes to outside lenders of the affiliates. EnTrade's board was largely oblivious about the gravity of these contingent liabilities, which constitute nearly 40 percent of the company's net worth.

   a. To extricate itself from this potential mess, EnTrade negotiates a stock-for-stock merger with DuoNergy (see §36.2). Under the merger agreement, DuoNergy will infuse new cash into EnTrade's online trading business, and EnTrade's shareholders will exchange their shares for shares of DuoNergy. The EnTrade board approves the merger and recommends it to EnTrade shareholders, but fails to become fully informed about the contingent liabilities or to mention them to the shareholders. Is this a breach of the directors' fiduciary duties?

   b. The court finds that the EnTrade directors breached their fiduciary duties to become informed in the merger. Are the directors liable for the shareholders' losses when the contingent liabilities, which DuoNergy assumed in the merger, force the acquiring company into bankruptcy?

Explanations

1. a. Sherron might bring a derivative action on behalf of the corporation to enjoin the directors from carrying out their expansion plan. She might claim the directors violated their duty of care to the corporation in approving the risky plan. Absent any indication of dishonesty, illegality, or conflict of interest, she could claim the directors were not sufficiently informed in approving the plan or that they could not have believed it was a valid business risk. MBCA §8.30(a) requires that directors

   - act in a manner that the directors reasonably believe to be in the best interests of the corporation
   - become informed in their decision-making function with the care that a person in a like position would reasonably believe appropriate under similar circumstances

   Sherron might argue the plan is improvident and no reasonable director could believe it would maximize corporate returns. See MBCA §8.31(a)(2)(ii)(A). She might argue the directors did not have enough information concerning the costs and risks of the expansion. See MBCA §8.31(a)(2)(ii)(B).

   b. Sherron might claim, on the same grounds she sought to enjoin the plan, that the directors be held liable for any damages proximately caused by their duty of care violation. See MBCA §8.31(b)(1). If the directors breached their care duties—because the plan is wasteful or the directors were grossly negligent in approving it—each director who approved it or was at the meeting and failed to object can be held liable (jointly and severally) for any losses the plan causes the corporation. See §8.24(d) (directors present at meeting deemed to have assented to action taken, unless dissent or abstention from action entered in minutes or by written notice).

   c. Next to none. The board's approval of the expansion plan is protected by the presumptions of the business judgment rule, which applies despite the broadly worded standards of MBCA §8.30. The rule insulates the board's decision from attack and shields the directors from liability. Under the business judgment presumption, Sherron must show one of the following:

   - the decision was *not in good faith* (tainted by fraud, conscious disregard, illegality, or a conflict of interest)
   - the decision was *wasteful* (cannot rationally be said to be in the best

interests of the corporation)

- the directors were *grossly negligent* (failed to inform themselves about the plan)

That is, a showing of negligence is not enough. Instead, Sherron must show bad faith, an utter lack of business justification, or a collapse in the decision-making process. She thus faces dismal odds of proving a care breach. Although MBCA §8.31 seems to codify *standards of liability* that parallel the MBCA §8.30 *standards of conduct*, courts have continued to superimpose the business judgment presumption despite statutory standards. Fiduciary standards, largely a matter of judge-made law, build on the principles of delegated risk taking and centralized management embodied in the business judgment rule.

2. a. Probably not support. Sherron could argue the telecommunications industry's aversion to online trading of bandwidth suggests the EnTrade directors could not reasonably believe the project was in the best interests of the corporation. See Official Comment to MBCA §8.30(a)(2) ("reasonably believes" includes objective element). But the business judgment rule is a formidable shield. To impose on corporate directors industry-wide caution would kill corporate risk-taking. Directors have broad latitude to experiment, and to fail, without being second-guessed or exposed to liability.

b. Probably not support. Although this information might be relevant to "like position" directors, the business judgment rule teaches that courts should not second-guess the process of business decision-making. Directors, of necessity, make decisions on incomplete information, often based on hunches and intuition. Lawyers can always dream up inquiries that the directors should have made, but the business judgment rule does not require courtroom-like thoroughness. The rule allows directors to act in an indeterminate business climate on imperfect information.

The few cases that have faulted directors for not making sufficient inquiries have generally arisen in the context of hostile takeovers (where directors have ineluctable conflicts of interest) and negotiated mergers (where directors face fewer long-term incentives). In their function of deciding operational matters, directors have had wide latitude to take risks and rely on information from corporate subordinates. See MBCA §8.30(d) (absent knowledge that makes reliance unwarranted, director entitled to rely on corporate executives whom the director reasonably believes to be reliable and competent in the information provided).

c. Probably not support. Even though Acosta's failure to mention the surveys may have been fraudulent—an intentional omission of a material fact—Sherron would have difficulty showing the board's reliance was unwarranted. See MBCA §8.30(d). She would have to argue that the board's approval of the expansion plan was tainted by fraud and unprotected by the business judgment presumption. If the board had reason to rely on Acosta (he had never been known to provide misleading information), then a shareholder challenge would be unavailing. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (*Cede II*) (concluding that a conflict of interest that affects one director does not necessarily remove board decision from business judgment rule). Of course, the board could later decide to fire or discipline Acosta—in fact, the possibility of such internal controls is at the heart of the business judgment presumption.

If, however, Sherron can show that reliance by the directors on Acosta's misleading presentation was unwarranted, the board action might be subject to attack. Personal liability of the directors, however, would be another matter. As in the cases involving directors' monitoring duties, directors making uninformed decisions are liable only if they should have known of management fraud.

In addition, consider Acosta's liability. Although the board decision might not be subject to attack, his misleading presentation might have violated his fiduciary duties as a corporate officer. See MBCA §8.42(a). If Acosta misled about the surveys for personal reasons, the business judgment rule would withdraw its protective presumption. Moreover, if it was obvious that the board would have wanted to know the full survey results, he could not have reasonably believed that withholding the information was in the corporation's best interests. Nonetheless, if there was some valid business reason for not describing the surveys fully or if it was a good-faith lapse, the business judgment rule would protect his actions.

d. Probably support. The business judgment rule does not protect a board decision if a director's conflict of interest may have tainted the decision-making process. See §13.2 (judicial suspicion of director self-dealing transactions). Although the board decision may be informed and the directors acted in good faith, where the transaction involves an interested director or senior officer, courts scrutinize the deliberative process and its outcome more closely. It would not be enough that the board merely knew of Acosta's conflicting interest. The board would also have to inquire into the fairness of the terms and price of Mastico's deal with EnTrade. See MBCA §8.60 (defining "required disclosure" in a director's conflicting interest transaction to include nature of conflict and facts respecting the subject matter of the transaction). The broad (and vague) care standards provide a convenient means for courts to adjust their scrutiny as the influence under which the board operates changes.

e. Probably support. The failure of outside counsel to fulfill its professional duties by conducting a slipshod investigation into a self-dealing transaction's terms and fairness can have repercussions on the transaction's validity. Not being informed on the critical issue of fairness can be the basis for invalidating the board's approval of the Mastico deal. See Official Comment to MBCA §8.62 (board approval of director's conflicting interest transaction "must be conducted in light of the overarching provisions of section 8.30(a)").

In addition, the Deere & Carbo lawyers may be subject to SEC discipline and sanctions under the new "up the ladder" reporting requirements. Under the rules, securities lawyers working for a reporting company (or one about to go public) must report "evidence of material violation" of the securities laws or breach of fiduciary duty by the company or its officials. 17 C.F.R. §§205.2, 205.3. The lawyer is first supposed to report the violation to the company's general counsel (or also the CEO) and, failing their response, to the board's audit committee or the board itself.

3. a. Perhaps. To overcome the business judgment presumption, a shareholder would have to show that the board's decision to expand the risk management program either was so improvident as to be beyond explanation or was grossly uninformed. The *possible* illegality of the test marketing, though a significant business risk, does not mean the

directors violated a duty to the corporation. Directors are not guarantors of corporate legality.

To show a breach of *substantive* care, Sherron would have to show the board proceeded without a rational business purpose. Any rational justification insulates the board's action from attack. For example, with energy trading increasing, the board could speculate that longer-term risk management products would fill an important market niche. These products would give the company a competitive advantage in the more competitive online energy trading market, and regulation is not certain. The CFTC's assertion of jurisdiction might be overturned on appeal. The CFTC might eventually authorize the product. And Congress might create a statutory exemption (which actually happened for Enron). A reasonable business person might conclude the *potential* benefits outweigh the risks—which is enough under the rational basis test.

To show a breach of *procedural* care, Sherron would have to show the board knew so little it could not have acted rationally. This will be difficult. The EnTrade board knew of the CFTC determination and relied on the opinion of counsel that a court might reverse it. Under the business judgment rule, the directors have significant latitude to assess the risks and benefits of a course of action, even if only with sketchy information.

b. Perhaps not. A shareholder could argue the directors are liable for not acting in good faith by approving illegal behavior. Earlier cases accepted this argument on the assumption corporate law should not shield those who disregard or flout the law. Imposing liability on directors promotes corporate responsibility. More recent cases recognize that directors act in an environment of legal uncertainty. At the time the directors approved the risk management expansion, it was not certain that CFTC approval was required to offer "hedge" contracts in its energy trading business. The directors could argue they reasonably relied on the advice of counsel that its risk management business would ultimately be found not to be subject to federal regulation.

Enforcing noncorporate norms (here financial capability laws) through corporate fiduciary law highlights the tension of making directors both agents of shareholder wealth maximization and guardians of legal compliance. This is particularly so if the CFTC regulations do not themselves penalize corporate decision-makers for selling a risk management product while its legality is being tested in court. The business judgment presumption arguably is not overcome unless directors know or have reason to know their action is illegal. See *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963). From the *standpoint of shareholders*, the corporation (or shareholders in a derivative action) should not be asked to police noncorporate responsibilities. These responsibilities are more appropriately enforced under the regulatory regime, as happened in this case when the CFTC sought an injunction and penalties against the corporation. If this is insufficient to deter unwanted decisions, they can be increased—as has happened, for example, with penalties imposed on corporations and corporate actors under the federal sentencing guidelines. See Sarbanes-Oxley §§805, 807, 903, 904, 905 (increasing jail sentences for mail and wire fraud, securities fraud, and ERISA violations, and mandating review of federal sentencing guidelines on obstruction of justice and white-collar fraud).

c. Yes. A failure to be attentive to corporate illegality may breach a director's duty of good faith (a subset of the duty of loyalty). The EnTrade directors violated their duty of good faith by failing to implement a monitoring system to detect illegal behavior—something effectively required by the Delaware courts. See *In re Caremark Int'l, Inc.*, 698 A.2d 959 (Del. Ch. 1996) (suggesting current law requires monitoring systems to detect both corporate illegality and management irregularities); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006 (accepting *Caremark* framework). The case for having a monitoring system is strong, as in EnTrade's situation, when there are indications corporate activities may be illegal.

4. a. Each director who was present at the meeting and failed to object or abstain from the action is assumed to have assented. MBCA §8.24(d). These directors may be held jointly and severally liable for the resulting loss suffered by the corporation. Consider the various excuses:

- Nessum, the absent director, is not liable under the MBCA, though some courts have imposed liability on absent directors who later acquiesced in wrongful board decisions.

- Adams, the abstaining director, is not liable so long as the minutes of the meeting reflect his abstention.
- Rowland, the nonparticipating director, is liable because she was present at the meeting. Unless during or immediately after the meeting she delivered written notice of an abstention or dissent, a procedure authorized by the MBCA, she is assumed to have acquiesced in the action.
- All directors who voted for the action are fully liable; there is no explicit right of contribution. Under the MBCA, they have no right to dissent or abstain once they have voted for the action.

b. Subject to an exculpation provision in the articles, the recused director is jointly and severally liable along with the other present, approving directors. Liability is to the corporation for all losses proximately caused by the board decision—namely the expansion of the risk management business. By failing to dissent, the nonparticipating director failed to register her views and perhaps remedy a mistaken decision.

c. Perhaps. Under MBCA §2.02(b)(4), in a corporation with an exculpation provision, a director can be liable for damages to the corporation or its shareholders only if his actions fit into one of four narrow categories. None seems to apply to the EnTrade directors in their approval of the expansion project:

- The directors did not receive financial benefits to which they were not entitled. The only exception might be any benefits Acosta received in connection with his interests in Mastico, the bandwidth consulting firm.
- The directors did not intentionally harm the corporation or its shareholders. On the assumption the directors believed that the risk management business would eventually be profitable and not subject to CFTC regulation, their approval represented good-faith business risk-taking.
- The directors did not approve illegal distributions, as defined in MBCA §6.40 (payments to shareholders). See MBCA §8.33 (liability for illegal distributions subject to standards of MBCA §8.30).
- The directors, from appearances, did not intentionally violate criminal

law. Although the directors understood there was a risk the company would violate CFTC regulations, there is no indication they or the corporation violated criminal law. Nonetheless, an argument could be made that an actual criminal conviction is not necessary and that engaging in risky financial arrangements is a criminal offense. This argument, however, would convert corporate fiduciary law into a prosecutor of criminal norms. See Official Comment, MBCA §2.02 (exculpation does not extend to "improper conduct so clearly without any societal benefit that the law should not appear to endorse such conduct").

The exculpation clause is meant to insulate directors from liability for well-meaning business risk-taking so long as the director does not enrich himself, does not carelessly approve unlawful distributions to shareholders (thus harming creditor interests), or consciously disregard potential harm to corporate interests or violation of noncorporate positive law. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (refusing to find breach of duty of good faith, on theory "bad outcome" cannot be equated with "bad faith").

d. Not necessarily. Even if the directors breached a duty for not inquiring sufficiently about the legality of the risk management business, their liability is not automatic. The MBCA places the burden on the challenging shareholder to show that the directors' inattention was a proximate cause of any corporate injury. See MBCA §8.31(b). This might be difficult if other causes, besides the lack of CFTC supervision, might explain the risk management losses. For example, if rogue traders caused the losses by having EnTrade assume unwarranted risks, the board's inattention to the CFTC issue might not be seen as the proximate cause of the losses. Moreover, a court might decide that even if the board had complete information about the CFTC jurisdictional issue, it would have reached the same decision. That is, the lack of information was not a proximate cause of the board's decision and the company's losses.

Some courts, including now those of Delaware, would shift the burden to the inattentive directors to show their decision was nonetheless entirely fair to the corporation—that is, the board adequately informed itself that the risk management business was a good business risk.

5. a. Perhaps. At first blush, it might seem that the EnTrade board's approval of the merger without becoming informed about and disclosing "bad news" at the company actually produced a windfall for EnTrade shareholders, and a major headache for DuoNergy. Nonetheless, once these contingent liabilities are assumed by DuoNergy, they will have a negative effect on EnTrade shareholders, who (remember) acquired DuoNergy shares in the merger. That is, the board has a duty to inform itself about the company's business, including the contingent liabilities that DuoNergy is acquiring, because these liabilities will be material to EnTrade shareholders once they own DuoNergy shares. The board in a merger must ascertain both the value of the company's assets and liabilities, and the value of the consideration that the shareholders are receiving. On both counts, the EnTrade directors' failure to become informed about such significant liabilities—and to tell the shareholders—would seem a breach of duty.

b. Not necessarily. Even though the EnTrade board should have become informed about EnTrade's liabilities when it sold the company, the shareholders' losses are not the result of the merger, but rather the earlier leveraging of the company's assets using company stock as collateral. In fact, bankruptcy would have been swifter and more certain had there not been a merger. Although the board should have become informed about this perilous leveraging of the company, and its failure may have violated the directors' fiduciary duties, this was not the failure that shareholders challenged. In fact, some Delaware cases hold that fiduciary breaches that existed before a corporate merger cannot be challenged by former shareholders—that is, the shareholders' fiduciary claims are lost in the merger. *Kramer v. Western Pacific Indus., Inc.,* 546 A.2d 348 (Del. 1988).

CHAPTER 13

Duty of Loyalty— Self-Dealing Transactions

A self-dealing transaction tests a fiduciary's loyalty to the corporation. When the fiduciary and the corporation are counterparties, the fiduciary plays two roles. She has a personal interest as a party to the transaction, and she participates in the corporate decision to approve the transaction.

This chapter discusses director self-dealing transactions—sometimes referred to as "director conflict-of-interest transactions." It describes self-dealing transactions (§13.1), the judicial approach to such transactions (§13.2), the various judicial fairness tests (§13.3), the statutory "safe harbors" (§13.4), and the remedies for self-dealing (§13.5).

Other chapters discuss other forms of self-dealing: the compensation of corporate executives (Chapter 14); parent-subsidiary dealings (Chapter 17); promoter's early dealings with the corporation (Chapter 29); and management buyouts and takeover defenses (Chapter 39). The taking of corporate opportunities and competing with the corporation, though also implicating the duty of loyalty, do not involve self-dealing with the corporation. See Chapter 16 (directors); Chapter 17 (controlling shareholders).

§13.1 NATURE OF SELF-DEALING

§13.1.1 Unfair Diversion of Corporate Assets

From the corporation's perspective, director self-dealing on unfair terms is like embezzlement. Little distinguishes the director who steals $100,000 from the company safe and the director who sells swampland to the corporation for $102,000 that is worth only $2,000. Although the land sale might seem like business as usual, the transaction effectively diverts to the transacting director corporate assets equal to the difference between the land's market value and its purchase price.

§13.1.2 Direct and Indirect Self-Interest

Self-dealing director transactions fall into two broad categories. In each instance, the director's conflicting interest risks that the transaction will be contrary to the corporation's best interests.

Direct Interest

In its classic form, self-dealing occurs when the corporation and the director herself are parties to the same transaction. MBCA §8.60(1)(i). Examples include

- sales and purchases of property, including the corporation's stock
- loans to and from the corporation
- the furnishing of services by a nonmanagement director (such as when the corporation's outside lawyer, accountant, or investment banker sits on the board)

Indirect Interest

Self-dealing also occurs when the corporate transaction is with another person or entity in which the director has a strong personal or financial interest. Courts generally look through the structure of the transaction to the substance of the director's interest. These include corporate transactions

- with the director's close relatives. See MBCA §8.60(1)(i), (3) (defining “related person” to include spouse, child, grandchild, sibling, parent, or family trust).

- with an entity in which the director has a significant financial interest. See MBCA §8.60(1)(i), (ii) (another entity in which director has a significant financial interest or in which he is a director, partner, agent, or employee).
- between companies with interlocking directors. See MBCA §8.60(1)(ii). In the case of a parent-subsidiary relationship, the duties of interlocking directors are subsumed in the question of the duties of the controlling shareholder. See Chapter 17.

§13.2 JUDICIAL SUSPICION OF SELF-DEALING TRANSACTIONS

Corporate law’s suspicion of director self dealing grows out of two assumptions. First, human nature tells us the self-dealing director will advance her own interests in the transaction to the detriment of the corporation. Second, the nature of group dynamics tells us the other directors will identify with their interested colleague even if they do not themselves have a financial interest in the transaction.

Nonetheless, transactions with insiders often make possible business deals that would otherwise be unavailable to the corporation from outsiders. Thus, modern corporate law allows self-dealing when “fair” to the corporation. Fairness is a multifaceted concept—a director satisfies her duty of loyalty if she is able to show the self-dealing transaction meets a mishmash of procedural and substantive tests.

§13.2.1 Early Rule of Voidability

Nineteenth-century courts, borrowing from the law of trusts, flatly prohibited self-dealing by directors. Self-dealing transactions, whether fair or not, were either *void* or *voidable* at the request of the corporation. The prohibition assumed that self-dealing rarely offers the corporation business opportunities not obtainable from other sources and that it is improbable that “disinterested” directors—those who do not have a direct or indirect interest in the transaction—will be immune to the actual and tacit influence of their interested colleagues.

§13.2.2 Substantive and Procedural Tests

The rule of voidability was abandoned at the turn of the century. See Marsh, *Are Directors Trustees?,* 22 Bus. Law. 35 (1966). Since then, courts have articulated a variety of substantive and procedural fairness tests. The substantive tests focus on the transaction's price and terms to measure whether the interested director advanced her interests at the expense of the corporation. The procedural tests focus on the board's decision-making process to measure whether the approving directors are disinterested in the transaction and independent of the influence of the interested director.

Over time, courts have articulated various review standards—with recent decisions focusing more on process than substance.

- **Substance plus process.** At first courts upheld self-dealing only if the transaction was fair on the merits *and* was approved by a majority of disinterested directors. See *Globe Woolen Co. v. Utica Gas & Electric Co.,* 121 N.E. 378 (N.Y. 1918) (invalidating one-sided supply contract entered with dominating director who failed to advise board of disadvantages).
- **Substance only.** By the 1950s, many courts upheld self-dealing if the court determined the transaction was fair on its merits. Approval by disinterested directors was not necessary.
- **Board process.** As the importance of outside directors grew in the 1980s, courts upheld director self-dealing provided disinterested, independent directors approved the transaction. See *Puma v. Marriott,* 283 A.2d 693 (Del. Ch. 1971) (upholding "independent business judgment" of disinterested directors who initiated and negotiated purchases from company's controlling family).
- **Shareholder process.** Courts have upheld self-dealing or shifted the burden to the challenger to prove unfairness—if disinterested shareholders (a majority or all) approved the transaction. Approval by disinterested directors has not been necessary.

The various tests ultimately turn on who decides whether the self-dealing transaction was in the corporation's best interests: a court, the board of directors, or the shareholders. See MBCA Chapter 8, Subchapter F, §§8.60-8.63 (comprehensive safe harbor for directors' conflicting interest transactions approved by appropriate action of directors or shareholders).

§13.2.3 Burden of Proof

Once a challenger shows the existence of a director's conflicting interest in a corporate transaction, the burden generally shifts to the party seeking to uphold it to prove the transaction's validity. See MBCA §8.61(b)(3) (absent disinterested approval by board or shareholders, transaction must be "established to have been fair to the corporation"); *Lewis v. S. L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980) (holding that interested defendants have burden of proving transaction between two affiliated corporations was fair and reasonable to the corporation).

Under the process-oriented approaches of the ALI Principles of Corporate Governance and Subchapter F of the MBCA, the challenger has the burden to prove the transaction's invalidity when disinterested directors or shareholders have approved the transaction. ALI §5.02(b); MBCA §8.61(b).

§13.2.4 No Business Judgment Presumption

The conflicts that permeate a self-dealing transaction rebut the business judgment presumption that directors act in good faith. See §12.3.1. Thus, for example, a company's sponsorship of a radio music program—normally subject to deferential review under the business judgment rule—becomes subject to intensive judicial review when the wife of the company's president was hired as a featured performer on the program. See *Bayer v. Beran*, 49 N.Y.S.2d 2 (Sup. Ct. 1944) (reviewing the process by which the board approved the program, the nature and quality of the program, and the wife's artistic competence and compensation).

Courts, however, have drawn a sharp distinction between directors who have an interest in the challenged transaction and "disinterested, independent directors"—that is, those directors who have neither a direct nor indirect interest in the transaction and are not dominated by the interested director. The business judgment rule protects from personal liability disinterested, independent directors who approve a self-dealing transaction in good faith. See §12.3.4.

One question that arises is whether self-dealing transactions can be sanitized by prior agreement or in the articles or bylaws. That is, can fiduciary duties be waived? "Fiduciary waivers" are recognized in LLCs, which are seen as more contractual than corporations. In fact, many LLC statutes permit the parties to agree to "specific types or categories of activities" that do not violate the duty of loyalty, provided the agreement is not "manifestly unreasonable." See ULLCA §103(b)(2). This is often given as a reason for choosing the LLC over the corporation. Courts, however, have been less willing to permit corporate agreements that waive the duty of loyalty in self-dealing transactions. See *Sutherland v. Sutherland,* 2009 WL 1177047 (Del. Ch. 2009) (agreement that placed corporate self-dealing transactions beyond judicial review would be "contrary to public policy"). Thus, the corporation remains less contractual, and more regulatory, than the upstart LLC form.

§13.2.5 Self-Dealing by Officers and Senior Executives

In general, officers and senior executives are subject to the same self-dealing standards as directors. See *Gantler v. Stephens,* 965 A.2d 695 (Del. 2009) (confirming that officers are subject to same fiduciary duties as directors); see also ALI §5.02(a), comment d. Nonetheless, because officers and senior executives generally will be expected to devote themselves primarily, if not exclusively, to the corporation, some cases indicate that such persons' transactions with the corporation are judged under more exacting standards.

§13.2.6 Aiding and Abetting Liability

Courts accept that an outsider who aids and abets a breach of fiduciary duty in a self-dealing transaction can also be liable. See *CDX Liquidating Trust v. Venrock Associates,* 640 F.3d 209 (7th Cir. 2011) (Posner, J.). Even though the outsider owes no fiduciary duties to the corporation, its "knowing participating" in the fiduciary's breach makes out a claim if the breach proximately results in damages to the corporation. See *Gatz v. Ponsoldt,* 925 A.2d 1265 (Del. 2007). But an outsider that merely negotiates with the board and seeks favorable terms for itself is not liable for aiding and abetting, but an outsider that attempts to exploit conflicts of interest on the board can become liable.

§13.3 JUDICIAL "FAIRNESS" TESTS

Under the traditional approach to self-dealing transactions, courts have applied both substantive and procedural standards of fairness.

§13.3.1 Substantive "Fairness"

A *substantive fairness* standard, first articulated by the courts in the 1940s, continues to be widely accepted. See *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. App. 1952) (requiring that self-dealing transaction be "fair and reasonable"). Under this standard, which examines whether the director's interests won out over the corporation's interest, courts accept the fairness of self-dealing if the court concludes the transaction was in the corporation's best interests. Substantive fairness—sometimes called "intrinsic fairness"—has two aspects:

- **Objective test.** The self-dealing transaction must replicate an arm's-length market transaction by falling into a range of reasonableness. Courts carefully scrutinize the terms of the transaction—principally the price.
- **Value to corporation.** The transaction must be of particular value to the corporation, as judged by the corporation's needs and the scope of its business.

Both aspects of the fairness test involve significant judicial meddling in business matters and, ultimately, a judicial evaluation of the transaction's merits. See *Shlensky v. South Parkway Building Corp.*, 166 N.E.2d 793 (Ill. 1960); Official Comment to MBCA §8.61 ("Note on Fair Transactions").

Some cases and commentators suggest that substantive fairness is a flexible concept that varies with the degree of self-interest. That is, the level of scrutiny increases (or decreases) with the intensity of the director's self-interest. For example, courts impose less scrutiny on transactions between corporations with interlocking directors compared to transactions with directors in their personal capacity. The MBCA reflects this differential review and treats an interlocking-director transaction as a “director’s conflicting interest transaction” only if so significant that it would normally require board approval. MBCA §§8.60(1)(ii), 8.61(a).

§13.3.2 Procedural “Fairness”— Process of Board Approval

Courts have also inquired into the process of board approval, showing various levels of deference if the transaction is approved by informed, disinterested, and independent directors. Courts sometimes refer to a combination of procedural and substantive fairness as “entire fairness.”

Judicial review of corporate processes examines whether the directors who approved the transaction (even disinterested ones) lacked independence and acceded to their interested colleague. In reviewing the process, courts have focused on three procedural elements: (1) disclosure to the board, (2) composition of the board (or committee) that approved the transaction, and (3) role of the interested director in the transaction’s initiation, negotiation, and approval.

Disclosure

Even when self-dealing may be fair on the merits, courts have invalidated the transaction if there was outright fraud in connection with its approval. Where there is no fraud, but only allegations of inadequate disclosure, courts have taken a variety of approaches. Some courts have said that full disclosure is a factor bearing on the transaction’s fairness; others have required that there be disclosure only of the conflict of interest to put the board on guard; still others have required full disclosure of all material information, including the profit the interested director stood to make in the transaction. See *State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co.,* 391 P.2d 979 (Wash. 1964) (invalidating transaction even though terms were fair on ground that director failed to disclose his interest). Each approach reflects different assumptions about whether full disclosure will give the board a meaningful opportunity to review the proposed transaction and to negotiate more favorable terms. See

ALI Principles, comment to §5.02(a)(1).

Board (or Committee) Composition

Some courts have upheld self-dealing transactions approved by disinterested directors, applying a less exacting standard of review that approximates business judgment deference. See *Puma v. Marriott,* 283 A.2d 693 (Del. Ch. 1971) (without inquiring into fairness, accepting “independent business judgment” of disinterested directors who initiated and negotiated purchases from company’s controlling family). Other courts, though while still reviewing the transaction’s fairness, have shifted the burden of proving unfairness to the plaintiff—if the self-dealing is approved by a majority of disinterested directors. See *Cooke v. Ollie,* 1997 WL 367034 (Del. Ch. 1997) (upholding loans by insiders to corporation in desperate need of funds). The ALI Principles combine both a burden-shifting and modified fairness standard; Subchapter F of the MBCA makes disinterested approval conclusive.

The directors who approve the self-dealing transaction must be both “disinterested” and “independent.” See *Orman v. Cullman,* 794 A.2d 5 (Del. Ch. 2002) (distinguishing “interest” and “independence” in case challenging fairness of merger involving company’s management). A director is “disinterested” if he has no *direct* financial interest in the transaction, or *indirect* financial interest through close family ties or business relationships, that would affect his judgment. He is “independent” if he is neither beholden to nor dominated by the interested director. *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co.,* 496 N.E.2d 959 (Ohio 1986) (applying Delaware law, domination means more than being selected by the interested director to serve on the board, but acting as requested without independent judgment).

Sometimes these concepts are conflated. For example, Subchapter F of the MBCA defines a “qualified director” as one who is not a party to the transaction, does not have a beneficial financial interest that would influence the director’s judgment, and has no familial, financial, professional, or employment relationship that would influence the director’s vote on the transaction. MBCA §8.60.

Role of Interested Director

Although earlier cases held that the interested director’s negotiation of a self-dealing transaction or her participation in the board's decision-making process invalidated the transaction, many modern statutes and recent cases allow the interested director to negotiate, participate, and vote without necessarily undermining the transaction's validity. See former MBCA §8.31 (replaced in 1989 by Subchapter F). An interested director's negotiation or participation, however, may evidence that the interested director dominated the other directors, undermining the advantage of disinterested approval.

Many modern statutes facilitate disinterested approval by easing quorum requirements for self-dealing transactions. Some statutes dispense with quorum requirements if the self-dealing transaction is approved by a majority of (but at least two) disinterested directors. See MBCA §8.62(c); former MBCA §8.31(c). These statutes overrule the early common-law rule that required disinterested directors to constitute a quorum of the full board. Other statutes allow interested directors to be counted for quorum purposes, even though they do not participate at the meeting.

What happens if an interested director discloses his conflict in a transaction with the corporation and then convinces his fellow directors that the transaction is nonetheless fair? At least one case holds that although disclosure may insulate the transaction from attack, the interested director remains liable for breaching his fiduciary duties. See *CDX Liquidating Trust v. Venrock Associates*, 640 F.3d 209 (7th Cir. 2011) (Posner, J.) (disinterested directors approved bridge loan in reliance on interested director, whose venture capital firm gave loan to company on terms highly favorable to firm). This approach seems a bit bizarre in that it would be possible for an interested transaction to be upheld because the conflict was fairly disclosed, while the interested director was held responsible for the transaction's unfairness. That is, the transaction could be both fair and unfair at the same time.

§13.3.3 Shareholder Ratification

Courts have shown substantial deference to self-dealing transactions approved or ratified by a majority of informed, disinterested shareholders.

Majority Ratification

Where a majority of the shares are cast by informed shareholders who neither have an interest in the transaction nor are dominated by those who do, most courts do not require that a defendant show “fairness.” Instead, courts review the transaction under the business judgment rule and shift the burden to the plaintiff to show the transaction constituted waste—that is, no person of ordinary sound business judgment would say that the consideration was fair. See *Aronoff v. Albanese*, 446 N.Y.S.2d 368 (App. Div. 1982) (shareholder majority approved self-dealing rent reduction and rent-free lease modifications).

Delaware courts have followed this approach in cases where the self-dealing was by a *noncontrolling shareholder*. In such a case, approval by informed, disinterested shareholders of a transaction with the noncontrolling shareholder not only extinguishes any claim the board had acted without due care, but also leads disloyalty claims to be viewed under the business judgment rule. See *In re Wheelabrator Technologies Litigation*, 663 A.2d 1194 (Del. Ch. 1995) (merger with 22 percent shareholder). Disinterested shareholder ratification of transactions with *controlling shareholders*, however, is less cleansing and only shifts the burden to the challenger to show unfairness. See *Kahn v. Lynch Communication Systems*, 638 A.2d 1110 (Del. 1994). The different standards reflect the concern that controlling shareholders are in a better position to manipulate or unfairly influence the process of the shareholder vote.

Critical to shareholder ratification is complete and fair disclosure to the shareholders. Thus, when a board pursued a reclassification plan that assured the incumbency of the company’s CEO and directors—rather than respond to an outside bid for the company—the Delaware Supreme Court held that shareholder approval of the reclassification plan was not sufficient to absolve the defendants. The shareholders had been misled, the court concluded, when they were told the board had conducted “careful deliberations” about the outside bid. Thus, the “entire fairness” standard applied to the interested transaction, not the business judgment rule or the proportionality *Unocal* standard (see §39.2.3). *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (cleansing effect of ratification does not apply when shareholders approve charter amendment, but only when shareholders approve board action that “does not legally require shareholder approval to become effective”).

Courts have been suspicious of self-dealing transactions if shareholder ratification is by a majority of shareholders interested in the transaction. *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. App. 1952); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976) (leaving burden with defendants to show “intrinsic fairness” of transaction ratified by interested shareholders). Under some conflict-of-interest statutes, including the MBCA, shares voted by an interested shareholder are not counted for purposes of shareholder ratification. MBCA §8.63(b); former §8.31(d). Nonetheless, many statutes permit a majority of shares held by disinterested shareholders to constitute a quorum. MBCA §8.63(c); former §8.31(d).

Unanimous Ratification

If self-dealing is ratified unanimously by all of the shareholders or by a sole shareholder, courts agree that it cannot be set aside even under a waste standard so long as there is no injury to creditors. Effective ratification depends on full disclosure to shareholders of the director’s conflicting interest.

§13.4 STATUTORY “SAFE HARBORS”

Because judicial self-dealing standards are often vague, there has been a movement toward adopting “safe harbor” tests that provide certainty to corporate planners seeking to ensure the validity of transactions between the corporation and its directors. Some courts, including Delaware’s, have interpreted “interested director” statutes (which ostensibly remove the cloud of voidability from self-dealing transactions) as creating a safe harbor so that properly approved self-dealing transactions are subject only to business judgment review. Likewise, Subchapter F of the MBCA and the ALI Principles of Corporate Governance adopt safe harbors meant to ensure the validity of self-dealing transactions if properly approved.

For each of the safe harbors, the initial question is whether there has been proper approval—that is, by qualified directors or qualified shareholders, at a meeting with the necessary quorum, and accompanied by adequate disclosure. If so, judicial review is muted or extinguished. If not, judicial review reverts to the common-law fairness standards described in §13.3.

§13.4.1 ”Interested Director” Statutes

Many modern statutes codify the abandonment of the flat prohibition against self-dealing, though without explicitly specifying when self-dealing is valid.

A good example is former MBCA §8.31(a) (rescinded in 1989), which states that a transaction *“shall not be void or voidable solely for the reason”* that a director (or an entity in which the director has an interest) is a party to a transaction with a corporation if

(1) the material facts are disclosed to the board, and a majority of disinterested directors authorized the transaction, or

(2) the material facts are disclosed to the shareholders, and the shareholders vote to approve the transaction (under some statutes the shareholders must be disinterested), or

(3) a court determines the transaction to be fair.

On their face, these “interested director” statutes are ambiguous. Do they merely reverse the common-law voidability rule for self-dealing transactions, leaving the *validity* of such transactions to judicial fairness review? Or do they create “safe harbors” that remove from judicial scrutiny properly approved transactions? Some courts have concluded the statutes do not displace judicial fairness review. See *Cookies Food Products v. Lakes Warehouse*, 430 N.W.2d 447 (Iowa 1988) (interpreting Iowa’s “interested director” statute to still require judicial review of “good faith, honesty, and fairness” in self-dealing transaction); *Remillard Brick Co. v. Remillard-Dandini Co.,* 241 P.2d 66 (Cal. App. 1952) (interpreting California’s “interested director” statute not to displace judicial role to ensure self-dealing transaction is “fair and reasonable”).

Delaware courts have wrestled with the state’s “interested director” statute. Del. GCL §144. At first, Delaware courts construed the statute as removing the shadow of automatic voidability, but without displacing the court’s role to measure the transaction’s entire fairness (both substance and procedure). See *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976). Delaware courts treated disinterested director approval as merely shifting the burden to the plaintiff to prove the transaction was not entirely fair. See *Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1134 (Del. Ch. 1994), citing *Kahn v. Lynch Communication Systems*, 638 A.2d 1110 (Del. 1994).

But, as Delaware has relied more and more on disinterested directors to resolve corporate conflicts, Delaware courts have concluded the statute creates a safe harbor for self-dealing transactions, if approved by fully informed, disinterested, and independent directors. *Marciano v. Nakash*, 535

A.2d 400 (Del.1987) (suggesting in dicta that proper approval "permits invocation of the business judgment rule"); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006) (upholding issuance of preferred stock to director, which was approved by committee of disinterested directors that considered alternative financing plans and received fairness opinion on challenged issuance). In effect, the Delaware courts have decided that properly informed and qualified directors are superior at determining the value of a self-dealing transaction to the corporation than a reviewing judge.

§13.4.2 MBCA Subchapter F

MBCA §8.61(b) —the heart of Subchapter F—validates a director's conflict-of-interest transaction if it was

- disclosed to and approved by a majority (but not less than two) of qualified directors (MBCA §8.62), *or*
- disclosed to and approved by a majority of qualified shareholders (MBCA §8.63), *or*
- established to be fair, whether or not disclosed (MBCA §8.61(b)(3)).

Judicial review of board approval is thus limited to whether the directors were "qualified directors" and whether the disclosures were adequate. Official Comment, MBCA §8.61(b). Although an earlier version of Subchapter F suggested a court had the latitude to determine whether the self-dealing transaction was "manifestly unfavorable to the corporation," the current Subchapter F makes clear that judicial inquiry is foreclosed if the criteria of the safe harbor are met.

Judicial review of shareholder validation is similarly limited to whether a majority of disinterested shareholders approved or ratified the transaction after requisite notice and disclosure of the conflict. Neither the MBCA provisions nor the official comments suggest the court should engage in any substantive review—such as for waste—if the process satisfied the statutory safe harbor.

Some commentators have criticized Subchapter F for effectively removing self-dealing substantive review from the courts and placing it in the hands of disinterested directors or shareholders. The subchapter, first adopted in 1989, has not been well received in states adopting the MBCA. As of 2011, only 15 of the 38 MBCA jurisdictions have included the subchapter.

Only a few cases have interpreted the Subchapter F safe harbor, though they suggest a judicial willingness to defer to internal corporate processes. In *Fisher v. State Mut. Ins. Co.,* 290 F.3d 1256 (11th Cir. 2002), an insurance company sold one of its subsidiaries to a newly formed corporation owned by two of the company's directors. The insurance company's board created a special committee, which negotiated and approved the sale. When a shareholder challenged the transaction, the corporation argued the sale satisfied the safe harbor for "board action" under Subchapter F. Despite allegations that the interested directors had failed to disclose material information about the subsidiary, the court held the interested directors' fiduciary duties to the purchasing corporation (which they themselves had formed) barred their full disclosure to the special committee, and they thus met the terms of the safe harbor. See MBCA §8.62(b) (full disclosure not required if interested directors disclose their interest and play no part in the deliberations or vote on the transaction). Given the safe harbor, the court refused to consider the plaintiff's further allegations of waste and fraud.

§13.4.3 ALI Principles of Corporate Governance

The ALI Principles of Corporate Governance also adopt a safe harbor approach. The Principles recommend a disjunctive test under which director self-dealing is valid if *after full disclosure*

- a court finds the transaction was fair when entered into, or
- a majority of disinterested directors (not less than two) approved or ratified the transaction, or
- a majority of disinterested shares approved or ratified the transaction.

ALI Principles §5.02. By requiring full disclosure in every case, the focus of judicial review is on disclosure adequacy even when the transaction is substantively fair or approved by disinterested directors or shareholders.

The ALI Principles contemplate diluted judicial review of the substance of a self-dealing transaction validated by disinterested directors. The court must conclude the transaction "could reasonably be believed to be fair to the corporation." ALI Principles §5.02(a)(2)(B). The burden, however, is on the challenger to show disclosure was inadequate, the approving directors were not independent, or the transaction fails this watered-down fairness standard. The ALI Principles, unlike the MBCA, specify that self-dealing transactions validated by shareholders remain subject to judicial review under a substantive waste standard. Thus, minority shareholders who vote against the transaction can still complain if no reasonable business person would conclude the corporation received fair benefit.

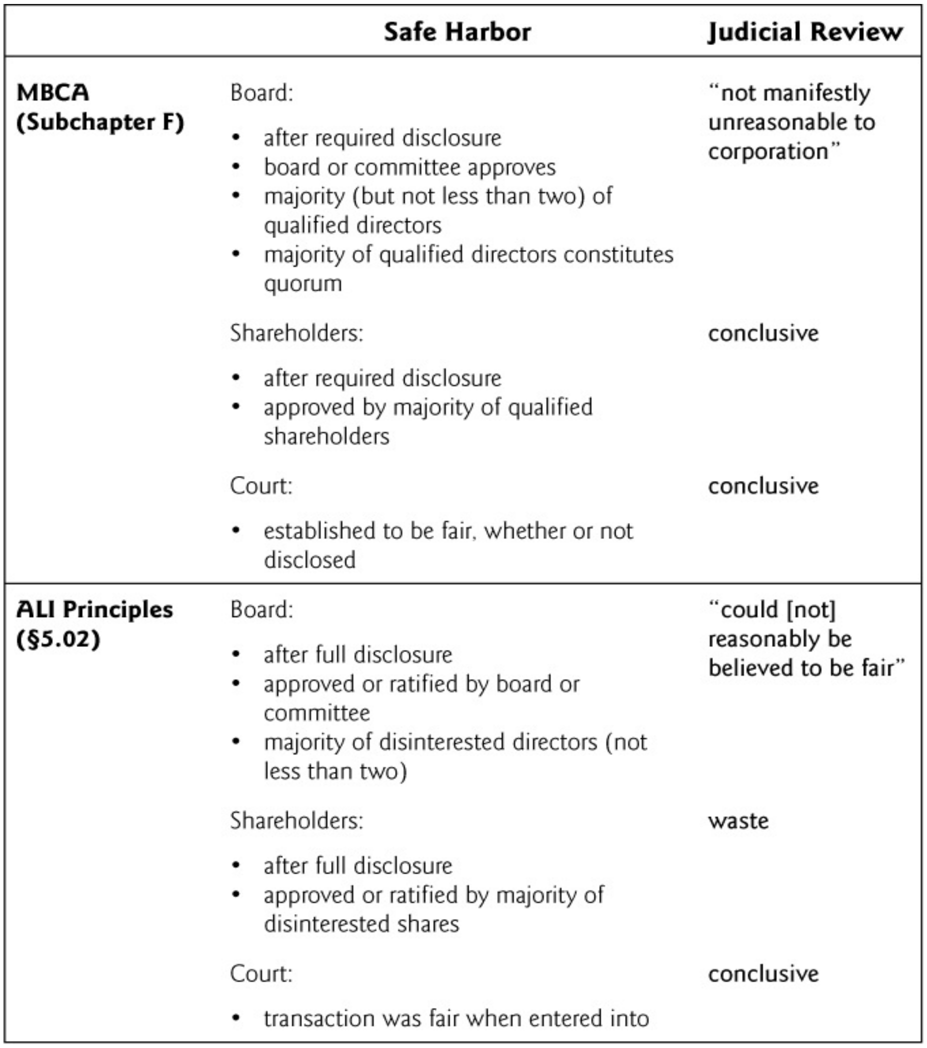
The ALI Principles treat self-dealing standards as default rules. Disinterested directors or shareholders can authorize in advance specified types of self-dealing transactions that can be expected to recur in the company's ordinary course of business. ALI Principles §5.09(a). This standard must be stated in the articles or bylaws, or by board or shareholder resolution. ALI Principles §1.36.

§13.4.4 Summary Chart

The following chart summarizes the safe harbor approaches under the Delaware "interested director" statute, the MBCA Subchapter F, and the ALI Principles:

	Safe Harbor	**Judicial Review**
Delaware (§144)	Board: • material facts disclosed or known to directors • board or committee in good faith authorizes • majority of the disinterested directors • disinterested directors may be less than quorum	business judgment presumption
	Shareholders: • material facts disclosed or known to shareholders • specifically approved in good faith by vote of shareholders	waste (?)
	Court: • transaction fair to corporation • as of time approved	conclusive

(continued)



	Safe Harbor	Judicial Review
MBCA (Subchapter F)	Board: • after required disclosure • board or committee approves • majority (but not less than two) of qualified directors • majority of qualified directors constitutes quorum	"not manifestly unreasonable to corporation"
	Shareholders: • after required disclosure • approved by majority of qualified shareholders	conclusive
	Court: • established to be fair, whether or not disclosed	conclusive
ALI Principles (§5.02)	Board: • after full disclosure • approved or ratified by board or committee • majority of disinterested directors (not less than two)	"could [not] reasonably be believed to be fair"
	Shareholders: • after full disclosure • approved or ratified by majority of disinterested shares	waste
	Court: • transaction was fair when entered into	conclusive

Although all three follow a similar approach, there are subtle differences. The ALI Principles, for example, require full disclosure to the corporate decision-making body, even if neither of the procedural safe harbors applies. Delaware does not require actual disclosure, if the material information is already known to the directors or shareholders. Moreover, each approach leaves room for judicial review of board approval—”good faith” in Delaware, “manifestly unreasonable” under the MBCA, and “reasonable belief” under the ALI Principles.

Just as the judicial standards of review are not uniform, so too the statutory standards!

§13.5 REMEDIES FOR SELF-DEALING

§13.5.1 General Remedy—Rescission

As a general matter, an invalid self-dealing transaction is voidable at the election of the corporation—either in a direct action by the corporation or in a derivative suit. The general remedy is rescission, which returns the parties to their position before the transaction. Normally, the corporation cannot seek to "renegotiate" the terms of the transaction by retaining the transaction's benefits, but at a lower price. After all, a self-dealing transaction may provide value to the corporation, and a director who transacts with the corporation should not be exposed to the risk the corporation will use a fairness challenge to renegotiate the deal.

§13.5.2 Exceptions to Rescission

A rescission remedy does not always work—such as when self-dealing is also the usurpation of a corporate opportunity (that is, the taking of a valuable business opportunity in which the corporation has a preexisting interest or that is within its line of business), or when the property has been resold and is no longer held by the original party. In such cases, the corporation may be entitled to damages instead of rescission.

For example, in *New York Trust Co. v. American Realty Co.*, 155 N.E. 102 (N.Y. 1926), a director resold to the corporation at a significant profit timberland that he had purchased only a few months before. Although the transaction was voidable under the then-prevalent "fairness plus validation" test because the director dominated the board, the corporation chose not to rescind. The court, while stating that normally rescission is the exclusive self-dealing remedy, held the director could be liable for his profits on an "agency" (or "corporate opportunity") theory without the transaction being rescinded. The director was required to account for his profits and became liable as though he had acquired the timberland for the corporation.

Examples

1. Last year major league baseball approved an expansion team in Havana, Cuba—after the island's admission to the Union as the fifty-first state. The team (the "Cuba Libres") is incorporated in an MBCA jurisdiction that has adopted Subchapter F. The largest shareholder of the Libres is Silvio Garcia (40 percent); the remaining shares are held publicly, mostly

by rabid Cuban baseball fans. Garcia, the board chair and company CEO, hand-picked the other four directors: Alejandro (his brother-in-law), Bobby (a prominent Cuban politician), Camilo (a prominent Cuban businessman), and Duncan (the company's outside lawyer).

a. Salsa Services operates a successful food concession business on the East Coast and has bid to operate food and beverage concessions for the Libres. Alejandro is a director and 25 percent shareholder of Salsa. Any problem if the Libres accept the Salsa bid?

b. Garcia calls a board meeting to consider the Salsa bid. Only Camilo and Duncan attend the meeting. The Libres bylaws specify that three directors constitute a quorum at board meetings. Do the two constitute a board quorum?

c. Both Camilo and Duncan had been personally invited to join the Libres board by Garcia. Neither owns shares in the team. Are the two qualified to approve the Salsa contract?

d. The two directors adjourn their meeting to ask Garcia for information about other bidders seeking the concession business. Garcia attends their reconvened meeting, answers their questions, and joins Camilo and Duncan in approving the Salsa bid. Does Garcia's presence and participation affect the validity of the board's action?

2. Ibrahim, a Libres shareholder, has waited his whole lifetime for baseball in Cuba. When he learns of the Salsa contract, he shouts, "It's a sweetheart deal." Salsa's three-year contract calls for Salsa to make flat payments to the Libres of $20 million per year for the right to be the team's exclusive concessionaire.

a. Ibrahim wants the Salsa contract invalidated. Assuming the bid was approved by the Camilo-Duncan committee, who should he sue and what will he have to show?

b. Ibrahim discovers that Alejandro, though he disclosed his directorship and 25 percent interest, never disclosed to the committee his inside knowledge that Salsa would have agreed to pay $24 million per year. Does Alejandro's failure to disclose Salsa's reservation price nullify the committee's approval?

c. Happieaux, another well-established food concessionaire and the only other bidder, had bid $14 million per year plus additional royalty payments of $4 for each fan who attends Libres games during the season. The committee, however, estimated annual attendance on the low end—1.4 million fans, producing for Libres $19.6 million in royalties. It chose the Salsa bid. Does this information indicate the Salsa contract is valid?

d. Ibrahim discovers an internal Libres study that projects attendance of 2.6 million, 2.8 million, and 3.0 million during the first three seasons. Garcia failed to disclose this study to the Camilo-Duncan committee. Does this invalidate the Salsa contract?

e. The Camilo-Duncan committee eventually became aware of the internal attendance study, though not from Garcia. The committee decided nonetheless to take the lower Salsa bid. Does this invalidate the Salsa contract?

3. At the next Libres shareholders' meeting, the board submits a shareholder resolution to ratify the Salsa contract. The company's proxy statement fully sets forth the terms of the contract, describes Alejandro's 25 percent interest in Salsa, and states the "Salsa contract assures the company a fixed payment not dependent on attendance figures."

   a. With Garcia (40 percent) voting for the resolution, it is approved by 55 percent of the outstanding shares. Most of the public shareholders vote against it. What effect does this shareholder ratification have on Ibrahim's challenge to the contract?

   b. The Libres articles of incorporation provide:

   > Any conflict-of-interest transaction between the Corporation and any director (or entity in which any director is interested) is conclusively valid if approved by a vote of a majority of the outstanding Shares. The Shares of any interested director may participate fully in such a vote.

   Does this affect the outcome of Ibrahim's challenge?

   c. Assume Garcia did not vote and a majority of public shareholders ratified the Salsa contract, though their shares did not constitute a majority. Would this vote affect Ibrahim's challenge to the contract?

4. The court rules that shareholder ratification was defective because the proxy statement failed to disclose the Happieaux bid, thus making the Salsa transaction unfair to the Libres.

a. Ibrahim wants the court to modify the Salsa contract to conform to the payment schedule offered by Happieaux, which the court had found was fair. Will the court order Salsa to make these payments?

b. Ibrahim had also sued Camilo and Duncan, the disinterested directors who approved the Salsa contract. Are they liable for the damages the Salsa contract caused the corporation?

Explanations

1. a. Yes. The concession could be rescinded as a director's self-dealing transaction because of Alejandro's and Garcia's conflicting interests. Alejandro's 25 percent shareholding in Salsa creates a "beneficial financial interest" that in all likelihood "would reasonably be expected to influence his judgment." See MBCA §8.60(1)(i). Moreover, even though nephews are not related persons under Subchapter F (see MBCA §8.60(3)), if Garcia's relationship with Alejandro is such that he would gain financially because of his Salsa holdings, he might have a "beneficial financial interest … of such financial significance" as to cloud his judgment. See MBCA §8.60(1)(i).

Subchapter F, though it specifies when a director's conflicting interest transaction is valid, does not specify when the transaction is invalid. Nonetheless, courts have scrutinized director self-dealing and would impose a heavy burden on Alejandro and Garcia to prove the procedural and substantive fairness of the transaction.

b. Yes. Under Subchapter F, as under most modern statutes, a majority of disinterested directors (but not less than two) constitute a quorum for purposes of considering a self-dealing director transaction. MBCA §8.62(c). The MBCA and other modern statutes relax the quorum requirement for the approval of self-dealing transactions so these transactions can be considered without interested directors present, thus facilitating impartial review by the disinterested directors. If Camilo and Duncan are "qualified directors," they would constitute a quorum.

c. Perhaps. It depends on whether Camilo (the Cuban businessman) and Duncan (the company's outside lawyer) are sufficiently disinterested and independent. If they are, the two would be fully capable—as a majority of qualified directors—to approve the self-dealing transaction, despite the absence of the other directors. MBCA §8.62(a).

If either Camilo or Duncan is interested or lacks independence, their action would fail under the MBCA safe harbor. MBCA §8.62(a) (at least two qualified directors). As the company's outside lawyer, Duncan might be disqualified in a variety of ways. If he or his law firm expects fees because of work connected to the Salsa deal, his financial interest in the transaction would constitute a "conflicting interest" under the statute. See MBCA §8.60(1). If Garcia "dominates" his activities as a director, perhaps because he feels beholden to him for continuing fees, his independence would be in doubt. This involves a factual assessment of motives and loyalties. As Justice Frankfurter once admonished judges, "[W]e should not be ignorant as judges of what we know as men." Nonetheless, Delaware courts have said that it is not conclusive merely because a director is selected by an interested director or controlling shareholder.

d. Yes, under the MBCA. The MBCA "safe harbor" for board action applies only if the qualified directors deliberate and vote "outside the presence of and without the participation by any other director." MBCA §8.62(a)(1). Other "interested director" statutes, however, are not as strict and specifically do not invalidate action by the board just because of the presence or participation of an interested director. See Del. GCL §144(a).

Even though the safe harbor is not available because of Garcia's presence and vote at the meeting, a court would still have to review the transaction for procedural and substantive fairness. The MBCA Official Comments define "fairness" as encompassing both "consideration and other terms of the transaction" and "process of decision the director's conduct." Official Comment, MBCA §8.60 ("fair to the corporation"). Among the fair dealing factors is whether the director exerted "improper pressure" on the other directors, presumably by being present and participating in the meeting at which the self-dealing transaction is considered.

2. a. Ibrahim should bring a derivative action (see Chapter 31) on behalf of the corporation and name the interested directors, Garcia and Alejandro, and the approving directors, Camilo and Duncan. Under Subchapter F the challenger must prove the director's conflicting interest and must establish that board approval (or any shareholder approval) was flawed. If he does, the directors then bear the burden to show the transaction

was fair. Failing this, the corporation can rescind the transaction. And the directors may be individually liable—the approving directors for their “lack of objectivity” under MBCA §8.31(a)(2)(iii), and the interested director for his “receipt of a financial benefit to which he was not entitled” under MBCA §8.31(2)(v). The business judgment rule would not apply, and there would be no presumption of validity.

b. Probably not. The Subchapter F safe harbor for self-dealing approved by disinterested directors requires that the interested directors disclose the “existence and nature of their conflicting interest” and all facts known to them about the transaction that an “ordinarily prudent person would reasonably believe to be material” to whether or not to proceed. MBCA §8.60(4) (“required disclosure”).

The duty to disclose *material* information puts the director in the uncomfortable position of a fiduciary and a self-interested counterparty. In this case, the discomfort is even greater for Alejandro, who owes fiduciary duties to Salsa not to disclose confidential information. The Official Comments to Subchapter F recognize this and suggest the director need not disclose all material information, but only that information the corporation would normally ascertain in an arm’s-length negotiation. Thus, the director need not “reveal personal or subjective information that bears on the director’s negotiating position.” For example, the director need not reveal “the lowest price he would be willing to accept.”

c. Probably. It may depend on the soundness of the committee’s attendance estimates. The fixed Salsa price ($20 million) is slightly better than the variable Happieaux price ($19.6 million), if the committee’s attendance estimates are valid.

If the transaction was approved by a majority of qualified directors, there would be no further review under the current MBCA’s safe harbor and the transaction could not be challenged. Instead, it would receive the business judgment presumption, requiring only that the decision was based on some rational business purpose. (An earlier version of the MBCA suggested that board approval of director self-dealing could be challenged if “manifestly unreasonable”—a standard less deferential than the business judgment rule, but more deferential than traditional fairness review.)

The current MBCA "safe harbor" approach is similar to that of Delaware under its nonvoidability statute. See *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006) (holding that Del. GCL §144 creates safe harbor, and thus protection of business judgment rule, for self-dealing transaction approved by informed, disinterested directors). The challenger carries the heavy burden to show something akin to waste.

d. Probably. The information would seem material, as it reveals that the variable contract (producing royalties of $24.4 million, $25.2 million, and $26.0 million) is superior to the fixed $20 million Salsa bid. Even though the interested Garcia's failure to disclose this study renders the Salsa contract unprotected by the safe harbor for disinterested director approval, a court could nonetheless conclude the contract was fair. That is, the board-approval safe harbor is not exclusive.

The fairness safe harbor of the MBCA, like judicial fairness review, contemplates judicial inquiry into the process of approval. Note on Fair Transactions, MBCA §8.61 ("course of dealing—or process—is a key component to a 'fairness' determination under subsection (b)(3)"). For example, the *Weinberger* "fair dealing" standard requires that the process of negotiation and approval of the self-dealing transaction conform to what would be expected of an independent board. See §17.3.3. This means the interested director should disclose all *material* information, and the approving directors may not be influenced by the interested director. Note on Fair Transactions, MBCA §8.61 ("most obvious illustration of unfair dealing arises out of the director's failure to disclose fully … hidden defects known to him regarding the transaction"). If the undisclosed attendance study would have added to information the board had on attendance estimates, it could be expected that Garcia would have disclosed it if he were not interested. As such, it is material and the board's approval does not insulate the transaction from review.

e. Not necessarily. If the committee's approval otherwise complies with the board-approval safe harbor, "neither the transaction nor the director is legally vulnerable" because of the director's conflict. See Official Comment, MBCA §8.61(b).

Even if the committee's approval failed to comply with the board-approval safe harbor, the transaction might still be saved if shown to be "fair to the corporation." The burden would be on the interested directors to show not only that the terms of the deal are comparable to what would have been obtained in an arm's-length transaction, but also that the transaction was likely to yield favorable results for the corporation. The behavior of the interested director—such as incomplete disclosure, exertion of improper pressure, or an untoward role in negotiating the transaction—may also be relevant to the court's evaluation of the fairness to the corporation. See Official Comment, MBCA §8.60.

3. a. Very little. The resolution was not approved by a majority of shares held by disinterested shareholders. MBCA §8.62(a), (b) (safe harbor requires majority of "qualified" shares be cast for transaction; "qualified" shares are those not owned or controlled by the interested director). In fact, a majority of disinterested shares were cast against the resolution. The burden will fall on Garcia and the other defendants to show the transaction's fairness.

   b. Perhaps, but only mildly. The MBCA allows for the articles of incorporation to contain limits on the power of the board and shareholders. MBCA §2.02(b)(5). But the Libres provision would effectively gut judicial review of self-dealing if the interested director, as here, controls the proxy mechanism or holds a significant block of stock. Just as courts have been unwilling to read statutory provisions as displacing judicial review of self-dealing transactions, there should be judicial reluctance to give a broad exculpatory provision full effect. Perhaps, as has happened in some cases, the reviewing court would merely shift the burden of proof to the challenger to show unfairness.

   The ALI Principles permit corporate parties to preapprove self-dealing transactions in the articles, but this dangerous practice is limited to "specified types" of self-dealing transactions that "can be expected to recur in the company's ordinary course of business." ALI Principles §5.09(a). The carte blanche provision in the Libres articles would not be binding.

   c. Yes. Ibrahim would have to show some defect in the process of shareholder approval, such as a failure to disclose the terms of the competing Happieaux bid or to describe the internal study estimating large attendance figures in the first three years. Like the board-approval safe harbor, shareholder approval must be accompanied by "required disclosure" of all material facts known to the interested director. MBCA §8.63(a). Absent a showing of some process flaw, the MBCA safe harbor provision treats the shareholder ratification as conclusive, without further judicial inquiry into the transaction's merits. MBCA §8.63. This is a significant departure from the prevailing judicial approach in such cases to either shift the burden to the challenger to show unfairness or to show waste.

The failure of the disinterested shareholders to constitute a quorum is not a problem. The MBCA, like many other statutes, requires only a majority of disinterested shares to constitute a quorum. MBCA §8.63(c).

4. a. Probably not. The usual remedy for unfair self-dealing is rescission of the transaction. This assures the self-dealing insider that the corporation cannot unilaterally revise the terms of the transaction in a judicial fairness challenge. If the royalties are indeed inadequate, the solution is to rescind the Salsa contract and for the corporation to find a better contract, presumably based on the Happieaux bid. In smaller corporations self-dealing transactions may be uniquely valuable, offering business opportunities to the corporation not otherwise available on the open market. The rescission-only rule keeps courts out of the business of reforming private arrangements.

b. Probably not. Because they were not interested in the transaction, they are liable only if they violated their duties of care. If they rationally believed that they were acting in the corporation's best interests and sought to inform themselves about the Salsa contract, their liability for approving the contract is protected under the business judgment rule. See §12.3. They may also be shielded from personal liability under any exculpation provision in the corporate charter. See §12.5.

CHAPTER 14

Executive Compensation

Executive compensation is the most common form of corporate self-dealing. But the rendering of managerial services by corporate executives is also an indispensable corporate activity. For this reason, executive compensation receives special judicial deference. When approved by disinterested and independent directors, executive compensation receives deferential business judgment review.

This chapter describes the various forms of executive compensation (§14.1), the different standards of judicial review (§14.2), the treatment of directors' fees (§14.3), and recent market and regulatory activities (§14.4).

§14.1 FORMS OF EXECUTIVE COMPENSATION

Modern corporate executives are compensated *directly* in a number of ways:

- **Salaries and bonuses.** Base salaries and bonuses, usually set annually, represent compensation for current services.
- **Stock plans.** Stock grants, stock options, and other plans based on stock value create incentives for executive performance; their purpose is to

align management and shareholder interests by pegging compensation to the corporation's stock price.

A *stock grant* by the corporation provides the executive a shareholding stake in the business, but dilutes other shareholders' interests.

A *stock option* granted by the corporation gives the executive the option during a specified period (often in the future) to buy a specified amount of the company's stock at a fixed price (often set above the stock's current market price). If the market price for the company's stock rises above the option's exercise price ("in the money"), exercising the option becomes profitable. When the executive exercises a stock option, the executive receives company shares, thus diluting the shares held by other shareholders. If the market price does not rise above the exercise price ("out of the money"), no shares are issued and the corporation's capital is not diluted.

Phantom stock plans and *stock appreciation rights* provide similar incentives without the corporation having to issue any stock (or, for that matter, have any stock authorized in the articles). The executive is credited with units on the corporation's books, and the value of the units rises or falls with the market price of the company's stock (including dividends and stock splits). The units represent a form of deferred compensation, and their value is not paid until a specified date, such as retirement or death.

- **Pension plans.** Pension plans and other forms of deferred compensation provide executives' retirement income. Plans qualified under the Internal Revenue Code make it possible for the corporation to immediately deduct corporate contributions to the plan even though the executive is not taxed until later.

Executives also are compensated *indirectly* with fringe benefits (perks), such as expense accounts, company residences, contributions to charities designated by the executive, and the use of corporate jets.

Stock Options

Understanding the operation of stock options is basic to understanding modern executive compensation. Let's assume that ABC Corp. is a public corporation, its common shares trading at $15 per share. The corporation grants stock options to its CEO, Martha, which give her the right (the option) to buy 5,000 shares at $15 per share after two years, but not beyond three years. This is like a lottery ticket for Martha; she wins if two to three years from now the stock price goes above $15.

Let's say the stock price after two years is $25. Martha can exercise her options and buy 5,000 shares from the company at $15, immediately reselling them in the market at $25 for a gain of $10 per share, or $50,000. Or Martha could hold on to the options (not exercise them) and hope the stock price rises even more before they expire in another year.

If, however, the stock price is only $12 after two years, Martha will not exercise the options, though they will still have value given the possibility that the stock price could go above $15 in the next year. But if the stock price stays flat, the options expire and she loses nothing—except her hopes for quick wealth.

Disclosure of Executive Pay in Public Companies

Under rules promulgated by the Securities and Exchange Commission (SEC), public companies must disclose in the company's annual proxy statement the compensation of their CEO, CFO, and three highest-paid executives. Exchange Act Schedule 14A (item 8), Reg. S-K, item 402 (see §§9.2, 9.3). Disclosure must be presented in tabular form covering the last three years of salary, bonuses, stock-based awards, nonstock incentive plan payments, retirement pensions, deferred pay, and perquisites. Any stock-based compensation must be presented as a dollar amount, reflecting the present value of any stock grants or stock options exercisable in the future, as well as amounts actually realized from stock-based awards. The table must then include a "total compensation" number.

In addition to disclosing this pay information, companies must discuss the objectives and implementation of their compensation programs (which the company's CEO and CFO must certify) and describe the process the board's compensation committee used to review and set the top executives' pay packages. Under the Dodd-Frank Act of 2010, public companies must also disclose the relationship between pay for the company's CEO and the company's financial performance. Dodd-Frank §953. Dodd-Frank also gives shareholders in public companies a "say on pay"—that is, the right to cast an *advisory vote* on the company's pay practices. Dodd-Frank §951. For example, shareholders can register their displeasure when there is a disconnect between pay and performance—such as when executive pay is going up at a company while the company's stock price is going down. See § 14.4.3 below.

These SEC-filed disclosures are carefully scrutinized by the business press, which uses them to report annually on the highest-paid executives and "grade" their relative value. Activist shareholders and proxy advisory firms also use the disclosures to identify companies where there is excessive pay or pay unrelated to performance. Companies failing to receive majority "say on pay" support from their shareholders have often changed their pay practices, sometimes even retroactively.

§14.2 JUDICIAL REVIEW

§14.2.1 Dilemma of Executive Compensation

Senior executives, particularly in public corporations, have significant sway over board decision-making. As a result, the board's setting of executive compensation raises many of the same concerns as are raised in director self-dealing transactions: (1) the executive predictably will prefer his own interests, and (2) the board will predictably accede to the executive's wishes, at the expense of corporate interests.

But treating executive compensation like any other self-dealing transaction would force courts to *regularly* place a value on a particular executive's services to the corporation, often without a working knowledge of the corporation, the particular value of the executive to the corporation, or the executive's market value to other corporations. Some commentators argue that judicial deference is warranted because most large corporations link executive pay significantly to corporate performance. Others, however, have looked at multimillion-dollar executive compensation packages and questioned the sufficiency of internal process and market limits alone. Board compensation committees, each trying to give "above average" compensation to their "above average" executives, have set into motion a seemingly boundless upward spiral in executive pay.

The accounting scandals of the early 2000s and the failures of risk management in the financial crisis of 2008 also raise doubts about creating incentives for executives (and other employees) with stock-based compensation, particularly stock options whose value depends on the company's stock price rising above the options' exercise price. By linking compensation to a rising stock price, the corporation creates the perverse incentive for the executives to manipulate the stock price through accounting gimmicks or to engage in overly risky business strategies.

§14.2.2 Compensation Authorized

Executive employment contracts, like any other transaction with the corporation, must be properly authorized. The shares for stock-based compensation must be authorized in the articles. MBCA §2.02; Del. GCL §151(a). Transactions involving the corporation's stock (such as stock grants, options, or repurchases) require board approval. MBCA §6.24; Del. GCL §152. In addition, some statutes require that stock options be approved by shareholders when the options, if exercised, would result in a substantial dilution of existing shareholders. MBCA §6.21(f) (requiring shareholder approval if options can be exercised to acquire shares that will comprise 20 percent of the voting power of shares outstanding immediately before option grant); see also NYSE Listed Company Manual Rule 312.03 (same for companies listed on exchange).

The board, particularly in public corporations, often delegates the task of reviewing and approving executive pay to a compensation committee of outside directors. MBCA §8.25(d); Del. GCL §141(c). Whether a director interested in his own compensation can be counted for quorum purposes, or vote for his own compensation, raises the same questions as in other self-dealing transactions. Some statutes authorize approval by less than a quorum of directors if disinterested directors approve the compensation. See MBCA §8.62(a) (board action effective if director self-dealing transaction receives affirmative vote of majority ([at least two]) of qualified directors); Del. GCL §144(a)(1) (approval of director self-dealing transaction by disinterested directors, even less than quorum).

One recent practice that ran afoul of the requirement that stock-based compensation be properly approved was the backdating of options, where the exercise price was not set using the company's stock price on the grant date but instead an earlier date when the stock price was lower. Such "backdated" options were thus immediately more valuable to those holding them because of their lower exercise price. Courts had little trouble concluding that the failure of compensation committees to follow the pricing rules of the company's stock option plans that had been approved by the board (and also the shareholders) was a violation of fiduciary duty, especially when the backdating was done in secret. See *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (finding that deliberate violation of shareholder-approved stock option plan and false disclosures rebut the business judgment rule and constitute bad faith, thus violating duty of loyalty).

§14.2.3 Disinterested Approval

Executive compensation is not subject to fairness review so long as it is approved by directors who are informed, disinterested, and independent. Stock listing standards for public corporations require that a majority of directors be independent (see §11.4); the listing standards, as mandated by Dodd-Frank, also require that all directors on the compensation committee be independent (see §14.4.4 below).

The board must be aware of all material information related to the executive's compensation, and the interested executive cannot dominate the board's decision-making. Courts have held that "back-scratching"—where officer-directors tacitly agree to approve each other's compensation, while each interested executive steps out of the meeting as his compensation is approved—does not satisfy the requirement of disinterested approval. See *Stoiber v. Miller Brewing Co.*, 42 N.W.2d 144 (Wis. 1950). But courts consider approval to be disinterested if nonmanagement (outside) directors or a committee of outside directors make compensation recommendations to the full board, even if the outside directors or committee constitute less than a quorum of the board and the full board is composed of a majority of inside directors.

In general, it is easier to muster *disinterested* board approval in a public corporation, where outside directors have become the norm, compared to a closely held corporation, where a majority of the board (if not the whole board) may have an employment relationship with the corporation. For this reason, compensation in a close corporation often turns on the approval or ratification by a majority of informed, disinterested shareholders. ALI Principles §5.03 (placing burden of proof on challenger to show waste if compensation approved by informed, disinterested shareholders).

Effect of Ratification

Over time, courts have changed their views on whether (and to what extent) approval or ratification by a majority of informed, disinterested shareholders affects judicial review. Some earlier cases, reflecting doubts about the informational efficiency of shareholder voting in public corporations, suggest that approval by informed, disinterested shareholders merely "freshens the atmosphere," and the burden falls on the directors to disprove waste. *Gottlieb v. Heyden Chemical Corp.*, 90 A.2d 660 (Del. 1952) ("possible indifference, or sympathy with the Directors, of a majority of the stockholders"). More recent cases, however, have concluded that shareholder ratification cleanses the transaction and shifts the burden to the shareholder challenger to show waste. *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (noting that in "this age in which institutional shareholders have grown strong," classic waste standard does afford some protection in egregious cases); *Harbor Finance Partners v. Huizenga*, 751 A.2d 879 (Del. Ch. 1999) (noting that if "fully informed, uncoerced, independent stockholders" approve compensation plan, "difficult to see the utility of allowing" plaintiff to prove compensation devoid of merit).

§14.2.4 Waste Standard

If executive compensation is approved by disinterested and independent directors, courts invoke the presumptions of the business judgment rule. One way the challenger can overcome the business judgment presumption is to show the compensation was a waste of corporate assets—that is, the compensation had *no relation* to the value of the services promised and was really a gift. See *Beard v. Elster*, 160 A.2d 731 (Del. 1960) (upholding approval by disinterested directors of stock options in "twilight zone where reasonable businessmen, fully informed, might differ"). Thus, for example, a post-death payment to an executive's widow not pursuant to any agreement lacks consideration and constitutes waste. *Adams v. Smith*, 153 So. 2d 221 (Ala. 1963).

The deference given disinterested and independent approval of executive compensation in a public corporation is illustrated by the much-litigated compensation paid the president and five vice presidents of American Tobacco during the Great Depression. *Rogers v. Hill*, 289 U.S. 582 (1933).

Under a bylaw adopted by American Tobacco shareholders in 1912, the executives received annual bonuses based on a percentage of the corporation's net profits above a stated base. As the company prospered, so did the executives. By 1930, with the Depression deepening and America smoking more, the president's annual bonus under the bylaw grew to $842,000 and each vice president's to $409,000—at a time when the average U.S. household income was less than $2,000 per year. Shareholders challenged the compensation as excessive under federal common law (before *Erie*). Although the amounts were staggering at the time, the Supreme Court gave "much weight" to the shareholders' near-unanimous approval of the bylaw and held that the bonuses could be challenged only if they were shown to be wasteful—that is, only if there was no relation between the bonus amounts and the executive services.

Even as executive compensation has lately spiraled upward, courts have honed close to the waste standard, dismissing complaints that the courts admit describe "exceedingly lucrative" compensation. Nonetheless, some cases suggest that allegations of wasteful compensation may raise factual questions that require further evidence. See *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (holding that "one time option grants to directors of this size" warrant the taking of evidence).

§14.2.5 Bad Faith Standard

Another way that a challenger can overcome the business judgment presumption—even when disinterested and independent directors have approved the compensation—is to show that the directors acted in bad faith. To show bad faith the challenger must show the directors "consciously disregarded" their duties in approving the compensation, either by not becoming informed or by engaging in a subterfuge or other deception of shareholders. For example, directors on a compensation committee violated their duty of good faith by approving executive stock options with an exercise price equal to the market price on the grant date when the directors knew that the company would be announcing favorable news soon after the grant date, causing the options to immediately rise in value. See *In re Tyson Foods, Inc.*, 919 A.2d 562 (Del Ch. 2007). The court held that such "spring-loaded" options are inherently unfair when concealed from shareholders.

Disney and Good Faith

The ongoing litigation over a $140 million severance package paid by the Walt Disney Company to Michael Ovitz, hired from Hollywood in 1995 to be the company's number two executive, illustrates the courts' deferential approach to executive compensation. The case, which was filed in 1998, was originally dismissed despite the "sheer magnitude of the severance package." *In re The Walt Disney Co. Derivative Litigation (Disney I),* 731 A.2d 342 (Del. Ch. 1998). On appeal, the Delaware Supreme Court expressed concern about the "lavish" payout and the board's "casual, if not sloppy" review of the package, but affirmed the dismissal, with leave to amend. *Brehm v. Eisner,* 746 A.2d 244 (Del. 2000).

After the plaintiffs amended their complaint, based on new information gathered after a statutory inspection of the company's books and records, the Delaware Chancery Court took a different tack. Concluding that the allegations painted a picture of directors who "consciously and intentionally disregarded their responsibilities," the court set the case for trial. In a move that garnered much attention, the court suggested that the directors had breached their duty to "act honestly and in good faith"—leaving open the possibility that the company's exculpation provision under Del. GCL §102(b)(7) (see §12.5) would not shield the directors from personal liability. *In re Walt Disney Co. Derivative Litigation (Disney II),* 825 A.2d 275 (Del. Ch. 2003).

After a protracted trial, the court concluded that the directors had not breached their fiduciary duties, even though their conduct "fell significantly short of the best practices of ideal corporate governance." *In re The Walt Disney Co. Derivative Litigation (Disney III),* 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). The chancery court concluded that enticing Ovitz to leave his high-profile position in Hollywood required making significant financial assurances if he were ever terminated. The failure of the directors to analyze the full ramifications of the pay package was "at most ordinary negligence." The court, however, hinted that the result might be different for a present-day pay package approved in "an era that has included the Enron and WorldCom debacles, and the resulting legislative focus on corporate governance."

§14.2.6 Fair and Reasonable Standard

When compensation has not been approved by informed, disinterested, and independent directors, it is subject to fairness review—and judicial scrutiny is substantial. The court takes on the function of the board (or compensation committee) and assesses whether the challenged compensation is fair and reasonable to the corporation, taking into account

- the relation of the compensation to the executive's qualifications, ability, responsibilities, and time devoted
- the corporation's complexity, revenues, earnings, profits, and prospects
- the likelihood incentive compensation would fulfill its objectives
- the compensation paid similar executives in comparable companies.

Full-fledged fairness scrutiny arises mostly for compensation in close corporations where boards (or committees) of disinterested directors are the exception. *Wilderman v. Wilderman,* 315 A.2d 610 (Del. Ch. 1974) ("standard for fixing executive compensation is obviously more strict when it is fixed by the recipient himself"). The scrutiny parallels that given executive compensation when the IRS challenges the deductibility of salaries as an "ordinary and necessary business expense."

§14.3 DIRECTORS' COMPENSATION

§14.3.1 Directors' Fees

Originally, directors served without compensation. Their reward was the increased value of their shares. As public ownership of corporations grew and shareholdings of directors declined, directors came to be paid relatively modest fees for serving on the board and for each meeting they attended. Today, as outside directors have become more important, directors' fees have become significant—sometimes totaling up to $100,000 per year and often in the form of company stock, though not stock options given the excessive risk taking the latter induce. In addition, directors are compensated indirectly through expense reimbursement, directors' liability insurance (see §15.2), corporate travel, and even product discounts.

Directors' fees authorized by disinterested shareholders are reviewable only if they constitute waste. See Official Comment to MBCA §8.61 (noting that director compensation, though universally accepted in principle, must be fair to the corporation or favorably acted on by shareholders). Even when directors' fees are not approved by shareholders, courts have been reluctant to intervene. See *Marx v. Akers,* 666 N.E.2d 1034 (N.Y. 1996) (dismissing claim that outside directors' increase of their own annual retainer to $55,000, plus 100 shares of company stock, did not constitute waste or "call into question whether the compensation was fair to the corporation").

§14.3.2 Compensation for Outside Services

Services provided by outside directors (or their firms) to the corporation—such as by lawyers, accountants, and bankers—are treated as self-dealing transactions subject to fairness review. For instance, if a lawyer sits on the board and her law firm provides legal services to the corporation, legal fees must be what would be obtainable in an arm's-length relationship and must be for services for which the corporation has a need.

§14.4 REGULATORY AND MARKET PRESSURE

Over the last decade, executive compensation has been controversial. News stories and books have chronicled the exorbitant pay of many American CEOs. In the words of a corporate compensation expert hired by many large corporations, "CEOs get paid hugely in good years and, if not hugely, then merely wonderfully in bad years." Graef Crystal, *In Search of Excess: The Overcompensation of American Executives* (1991).

Over the past few decades, while inflation-adjusted pay for most workers has been stagnant, the pay for corporate CEOs has skyrocketed. In 2010 the median pay package for a CEO at an S&P 500 company was $7.5 million, compared to the average private sector employee's annual pay of $40,000. Thus, the ratio in 2010 between the pay of the average CEO and that of the average worker was about 185:1. This compares to a ratio of 24:1 in 1965, 125:1 in 1993, and 290:1 in 2001. This disparity in the sharing of the financial returns in large U.S. public corporations has been controversial—and various federal laws have been enacted in response.

§14.4.1 Securities and Tax Laws

During the 1990s, federal regulators responded to the public outcry against overpaid executives and sought to impose some discipline.

SEC Disclosure

In 1992 the SEC significantly revised its rules on disclosure of executive compensation in public companies. See §14.1. Although there was some hope that these disclosures would shame board compensation committees into reining in compensation excesses, the greater information fueled an upward spiral as companies sought to out-compensate each other.

The SEC has continued to tinker with its disclosure rules. See Exchange Act Rel. No. 54,302A (2006) (requiring new Compensation Discussion and Analysis section and summary compensation table, including a present dollar value for stock-based compensation). In addition, Dodd-Frank requires disclosure about the role of (and potential conflicts) involving executive pay consultants, as well as additional disclosures comparing CEO pay and the company's financial performance. See Dodd-Frank §§952, 953 (see §14.4.3 below).

Tax Deductibility

In 1993 Congress revised the tax laws to disallow corporate deductions for executive compensation to the CEO and four highest-paid executives in excess of $1 million per year. An exception is made for compensation based on performance goals (1) determined by a compensation committee composed solely of outside directors, (2) approved by shareholders after disclosure of material terms, and (3) certified by the compensation committee to have been met. See I.R.C. §162(m). The 1993 tax change induced companies to increase incentive compensation (particularly stock-based compensation) linked to the companies' market performance.

An interesting question that the tax-deducibility provision raises is whether a board of directors commits "waste" if it approves executive pay that is not tax-deductible. In 2013, the Delaware Supreme Court affirmed the dismissal of a claim of corporate waste where a board had approved a $130 million executive compensation package that lacked full tax deductibility. The court explained that executive pay was not reviewable as waste unless it were shown that the corporation had given "something away for free."

Freedman v. Adams, 58 A.3d 414 (Del. 2013) (holding that informed, independent directors had no duty to structure executive pay package to take advantage of corporate tax deduction).

§14.4.2 Sarbanes-Oxley Act

In 2002, responding to stories of management abuse in companies hit by scandal, Congress took aim at abusive compensation practices.

Prohibition of Loans to Insiders

Sarbanes-Oxley prohibits public companies from giving "personal loans" to directors and executive officers. Sarbanes-Oxley §402; Exchange Act §13(k). A limited exception is available for loans to insiders made in the normal course of the company's business, such as credit cards offered by a bank to its executives on the same terms as offered to other customers.

The federal prohibition, which displaces state law, has forced companies to reassess such common practices as travel advances, personal use of company credit cards, retention bonuses (reimbursable if the executive leaves), indemnification advances by the company (reimbursable if the executive ultimately is not entitled to indemnification), loans from 401(k) plans, and cashless exercise of stock options (where the company or a broker gives the executive a short-term loan so the executive can exercise the options and then repay the loan once he sells the underlying shares).

Escrow during SEC Proceedings

Sarbanes-Oxley authorizes the SEC to seek a judicial order for the escrow of "extraordinary payments" made to corporate executives pending the outcome of an investigation and any charges against them. Sarbanes-Oxley §1103; Exchange Act §21C(c)(3). A recent case interpreted "extraordinary payments" to include "restructuring payments" of $37.6 million made to a company's CEO and CFO after they resigned their corporate offices to become "employees" of the company. *SEC v. Yuen*, 401 F.3d 1031 (9th Cir. 2005). The court determined the termination payments were "extraordinary" given both the unusual circumstances surrounding their approval (they were made after allegations that the company had overstated its revenues) and their relative size (they were five to six times larger than the executives' base salary in the previous year).

SEC Clawbacks of Incentive Pay

Under Sarbanes-Oxley, if a public company is required to restate its financial statements as a result of "misconduct," the company's CEO and CFO must reimburse the company for any incentive pay (such as bonuses or equity-based compensation) received from the company during the 12-month period after the misstated financials were issued or filed. Sarbanes-Oxley §304; 15 U.S.C. §7243. The provision raises a variety of uncertainties—not the least of which is whether the reimbursement action may be brought only directly by the company, or indirectly in a derivative suit, or through an enforcement action by the SEC. Also unclear is what constitutes misconduct and whether the CEO or CFO subject to reimbursement must have actually engaged in the misconduct.

Lower courts have held that §304 does not imply a private cause of action, but can be enforced only by the SEC. See *Cohen v. Viray,* 622 F.3d 188 (2d Cir. 2010). In the years following the adoption of §304, the SEC was criticized for not bringing any actions to enforce the clawback remedy. But beginning in 2009, the agency began to seek clawbacks from company executives under §304, including in cases where they were not personally involved in the misconduct that led to the financial restatements.

§14.4.3 Dodd-Frank Act

The Dodd-Frank Act again addressed the issues of executive compensation in public companies, responding especially to the public outcry against what was perceived as excessive executive pay at financial firms receiving government bailouts during the financial crisis of 2008. The Dodd-Frank reforms primarily focus on increased disclosure and greater shareholder input in pay practices.

"Say on Pay"

One of the most important contributions of Dodd-Frank is to provide shareholders an advisory (nonbinding) vote on executive pay in public companies. See Dodd-Frank §951(a) (adding Exchange Act §14A). Companies must include on the proxy ballot a chance for shareholders to vote for or against the pay packages of the company CEO and the four other top-paid executives. The vote must take place at least every three years, though companies (as most have) can opt to make the vote annual.

In the first years of "say on pay," most companies have received more than 90 percent support for their pay packages, but when companies have received weaker support, especially when they received less than majority support, company boards often revised pay packages and even reduced pay retroactively. In addition, many of the handful of companies receiving negative "say on pay" votes have been sued. Shareholders have claimed that the directors failed in their fiduciary duties or engaged in corporate waste. Most of the suits have been dismissed, but some have withstood motions to dismiss. Although "say on pay" has not unleashed a revolution in executive pay practices, as some proponents had hoped, it has resulted in a new dynamic in shareholder-management relationships.

Golden Parachutes

Dodd-Frank also gives shareholders an advisory vote on executive pay packages arising in mergers or other corporate acquisitions. Dodd-Frank §951(b) (adding Exchange Act §14A). Whenever shareholders are asked to approve an acquisition, the company must also provide full disclosure of any special pay arrangements for departing company executives, such as "golden parachutes" (see Chapter 34). Thus, shareholders have a chance to voice their displeasure if executives in a poorly performing company receive a windfall for having mismanaged the company.

Company Clawbacks of Incentive Pay

Seeking to strengthen and expand the clawback remedy adopted in Sarbanes-Oxley (see §14.4.2 above), Dodd-Frank mandates that exchanges *require* listed companies to adopt procedures to recover up to three years of incentive pay from the company's executives (both current and former) whenever the company is forced to restate its financials. Dodd-Frank §954 (adding Exchange Act §10D). The new approach covers more executives than just the CEO and CFO; it expands the clawback period from one year to three years; it applies to all restatements, not just those due to misconduct; but it requires a clawback only of incentive-based pay that exceeds what would have been paid under the restatement. If the company fails to seek a clawback, the SEC can bring an action against the corporation to enforce the recovery, though (as with §304) there is no express private cause of action. As of 2014, most public companies had adopted clawback policies, even though the SEC had not yet promulgated new clawback rules as required under Dodd-Frank.

Compensation Disclosure

Dodd-Frank adds new disclosures to the proxy statement. First, it requires that companies show “the relationship between executive compensation actually paid and the financial performance of the issuer.” Dodd-Frank §953(a) (adding Exchange Act §14(i)). The disclosure of “pay versus performance” mirrors the growing view among shareholders that executives not reap rewards while their company fails. For example Kerry Killinger (the former CEO of Washington Mutual) was paid $25.1 million during 2008—the year that Washington Mutual collapsed under the weight of its ill-advised subprime mortgage exposure, was seized by the federal government and sold to JPMorgan for a fraction of its book value, and then filed for Chapter 11 bankruptcy.

Dodd-Frank also requires companies to determine and disclose (1) the total median compensation of all employees with the exception of the CEO, (2) the total compensation of the CEO, and (3) and the ratio of these two numbers. Dodd-Frank §953(b) (requiring the SEC to amend Item 402, Reg. S-K). The ratio, it has been said, can easily be manipulated by companies that outsource many low-level tasks, thus ensuring than non-CEO employee pay is relatively high and the ratio relatively low.

Finally, Dodd-Frank requires that the annual proxy statement include information on whether company officials are allowed to hedge any decrease in the company’s securities—and thus bet against the company’s financial performance. Dodd-Frank §955 (adding Exchange Act §14(j), requiring the SEC to issue rules).

§14.4.4 Shareholder Activism

Institutional shareholders also have targeted companies with high executive compensation compared to performance. Activist shareholders have used the SEC’s shareholder proposal rule to urge compensation reforms (see §9.4.2), and institutional shareholders and proxy advisory firms have become increasingly involved in direct discussions with boards and compensation committees on pay issues. Proxy advisory firms, which advise institutional investors on exercising their voting rights, have created templates of acceptable terms in compensation plans—such as the ways that pay packages should ensure that executives are not paid for failure or the repricing of “out of the money” options. Compensation committees must be sure their plans satisfy these templates.

In addition, the advisory “say on pay” votes by shareholders—required by Dodd-Frank in all public companies beginning in 2011—have led companies, particularly those that have received negative votes for their pay practices, to amend their pay packages to match pay with performance and to provide clearer disclosure to shareholders on how pay is consistent with shareholder interests. Companies that have received negative votes have also been subject to shareholder suits against directors, alleging violations of fiduciary duties for approving (unpopular) pay packages.

Examples

1. More Parking Corp. (MPC), incorporated in Delaware, is in the glamorous business of owning and operating parking garages. Leonard More, the company’s founder, is board chair, company president, and a 30 percent shareholder. The remaining shares are publicly held; no other shareholder holds more than 5 percent.
    a. More’s three-year executive compensation contract is coming up for renewal. The MPC board is composed of seven directors: More, three company executives, and three nonmanagement outside directors. Advise the board on how approval of the contract should be handled.
    b. Would you recommend the board seek to have shareholders ratify the contract?
2. The MPC forms a compensation committee of three outside directors, who approve a five-year compensation package for More of $400,000 in annual salary and a bonus of 5 percent of net earnings. The committee knows the package is generous. At current earnings levels, More will make $650,000 each year, compared to the $200,000 per year that top executives in the parking garage industry are paid.
    a. Cheryl, a long-time MPC shareholder, is outraged and wants to challenge More’s compensation. She brings a derivative suit. What must she allege?
    b. Is there other action she can take?
3. The compensation committee, at More’s request, also provided for his

retirement. After the three-year contract term, More can retire from the company and, by making himself available exclusively to the company, receive a guaranteed annual consulting fee of $400,000 a year, whether or not he actually performs consulting services.

a. Cheryl is even more irritated when she learns of the consulting arrangement. Will she succeed if she challenges the consulting arrangement as a waste of corporate assets?

b. The directors are worried about Cheryl's challenge. How might they change the consulting agreement to bolster its validity?

Explanations

1. a. Most lawyers advise the board to delegate the task of reviewing and negotiating the contract to a committee of directors, all of whom are nonemployee outside directors. This structure will avoid any claim that management directors set his compensation under a "back-scratching" arrangement where each director tacitly agrees to support each other's compensation. It will also avoid uncomfortable disclosure of committee conflicts under SEC disclosure rules. The committee should have access to all information about More and the company and should hire its own compensation consultant to provide pay information on comparable executives. It would be advisable that More not be present when the committee deliberates in order to avoid the appearance that he dominated or controlled the committee. If approved by directors who are informed, disinterested, and independent, More's compensation will be reviewable only under a forgiving waste standard.

b. Probably. Under Delaware law, even if board approval is found to have been misinformed or tainted, shareholder ratification has a cleansing effect and shifts the burden to the plaintiffs to show waste. *Lewis v. Vogelstein*, 599 A.2d 2 (Del. Ch. 1997).

Federal tax laws change the calculus for submitting pay packages for shareholder approval, particularly executive compensation above $1 million per year. Shareholder approval of performance goals is necessary for such compensation to be deductible. Although prior practice had been to submit only stock plans (authorization in the articles) for shareholder authorization, modern boards now regularly submit executive compensation plans for shareholder approval.

2. a. She must make allegations that rebut the business judgment presumption—a nearly insuperable standard. There are several possibilities suggested by the facts: (1) the directors failed to become informed, (2) the directors failed to act in good faith, (3) the directors were dominated by the interested director, or (4) the compensation was wasteful. If there were factual support, Cheryl might also allege that the compensation was specifically forbidden in the articles of incorporation or the compensation was illegal.

Cheryl might first allege that the committee failed to become informed about comparable pay in violation of its duty of care. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (see §12.3.3). Although a showing of gross negligence will support an injunction against the improperly approved pay, the committee members would not be individually liable for any damages to the corporation if the corporation has an exculpation proviso as provided by Del. GCL §102(b)(7) (see §12.5).

Next Cheryl might allege that the committee failed to act with good faith. If the committee approved the pay package, while consciously disregarding whether it was justified in light of comparable pay for comparable services, it would violate its duty of good faith. See *In re Walt Disney Co. Derivative Litigation (Disney II)*, 825 A.2d 275 (Del. Ch. 2003). Not only would the pay package be voidable, but the committee members could be individually liable because any exculpation cannot cover acts not in good faith. Del. GCL §102(b)(7) (see §12.5).

Next Cheryl might allege that More "dominates" the outside directors by virtue of his position as chairman and 30 percent stock owner—rendering the directors not independent and their approval a loyalty breach. "Domination" is a slippery and highly factual standard. Courts have held that generalized allegations of share ownership and position on the board are insufficient to establish domination. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (essentially the facts of this example). Instead, Cheryl would have to show the directors acted as requested without independent judgment.

Finally, Cheryl might allege the compensation is a waste of corporate assets—that is, no reasonable business person would say that the compensation had any relation to the services received and that it was in reality a gift. *Lewis v. Vogelstein*, 599 A.2d 2 (Del. Ch. 1997). Mere allegations of a discrepancy between the compensation and pay to comparable executives, though sufficient under a fairness standard, would not be enough. The committee (and More) could defend the compensation by pointing to his experience with the company and other possibly unique attributes. Courts are reluctant to become involved in these matters of business judgment.

b. Cheryl might submit a shareholder proposal on executive compensation to be included in the company's proxy statement. Under Rule 14a-8, the proposal cannot demand the directors set a given pay, but can make precatory (advisory) recommendations or ask for the compensation committee to report on why More's compensation is more than three times higher than that of comparable executives. In 1992 the SEC changed course and now considers shareholder proposals on executive compensation to be includable under the rule.

3. a. Probably not. Cheryl would argue the consulting fee, by its terms, is unrelated to any services to the corporation. She could assert that there is no assurance More will actually provide the services; there is no indication the corporation will actually consult him; and whatever services he provides will be of little value and would be available from other sources for less money.

Despite these arguments, Cheryl will have an uphill fight. The directors (and More) can argue that his consulting services are unique and his *exclusive availability* will have great value to the corporation. Although outside consulting services can often be purchased for less than inside executive employment, courts have recognized the value of building up institutional knowledge and intuition. In addition, even if the consulting pay is argued to be unrelated to actual consulting services, it can be seen as deferred compensation for the five-year employment contract. Similar challenges to a comparable executive compensation package failed to impress the Delaware Supreme Court. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

b. The compensation committee could provide that the consulting fee is contingent on More's agreement not to compete with the corporation. The committee should also make clear that the consulting fee is not necessarily related to future services, but rather to the noncompete agreement or the five-year contract. Courts have invalidated compensation tied to future services where there was no assurance the services would be performed.

CHAPTER 15

Indemnification and Insurance

In our litigious society, being a corporate official is risky business. Corporate directors and officers can be named in private lawsuits brought by shareholders, third parties, or in governmental proceedings challenging corporate behavior. To encourage qualified individuals to accept corporate positions and take good-faith risks for the corporation, corporate statutes permit (and sometimes mandate) the corporation to indemnify directors and officers against liability arising from their corporate position (§15.1). Directors' and officers' (D&O) insurance supplements this protection (§15.2).

Indemnification and insurance represent two of the legs of the four-legged stool on which directors sit. The other two are the protection under the business judgment rule (see §12.2) and liability exculpation authorized by corporate statutes, such as Del. GCL §102(b)(7) (see §12.5).

§15.1 INDEMNIFICATION— CORPORATE REIMBURSEMENT

What is corporate indemnification? It is simply the corporation's reimbursement of litigation expenses and personal liability of a director sued because she is or was a director. (Indemnification of officers and other corporate agents is similar and is discussed below.) In general, indemnification applies when the director is or was (or is threatened with being made) a defendant in any civil, criminal, administrative, or investigative proceeding. A director's indemnification rights continue even after she has left the corporation.

Open-ended corporate indemnification undermines directorial accountability under corporate law and other noncorporate regulatory schemes. For example, if directors could act with impunity to authorize the corporation to deceive investors or dump toxic chemicals, confident they would be held harmless if ever sued, the deterrent effect of personal liability under the securities and environmental laws would be undermined. Moreover, if the corporation indemnifies directors who breach their fiduciary duties to the corporation, the compensation and deterrence goals of fiduciary liability are effectively nullified.

Because of indemnification's potential to frustrate other goals and policies, a director's right to indemnification and the power of the corporation to indemnify depend on whether

- the director was successful in defending the action or
- the director, though unsuccessful in her defense, was justified in her actions (for example, by seeking in good faith to promote the corporation's interests in a legally ambiguous situation).

Generally, indemnification rights are fixed by contract or the corporation's constitutive documents (articles of incorporation or bylaws). See MBCA §2.02(b)(5) (permitting indemnification in articles of director's conduct to same extent corporation can exculpate liability for such conduct). Statutory indemnification provisions provide the framework for drafting, interpreting, and enforcing contractual indemnification rights. See MBCA Chapter 8, Subchapter E, §§8.50-8.59; Del. GCL §145.

Note on Indemnification of Nondirectors

In general, the corporation may indemnify nondirector officers, employees, and agents to the same extent as directors. MBCA §8.56

(official comment that corporation has power to indemnify employees and agents); Del. GCL §145(a). Indemnification of officers (though not others) is mandatory to the same extent as if the officers were directors.

§15.1.1 Mandatory Indemnification for Successful Defense

If a director is sued because of her corporate position (such as for approving a corporate decision or issuing a corporate statement) and she defends successfully, the corporation is *obligated* under all state statutes to indemnify the director for litigation expenses, including attorney fees. MBCA §8.52; Del. GCL §145(c). The right of the successful director to claim repayment of expenses is available whether the suit was brought on behalf of the corporation or by an outside party.

The right protects a director from the corporation's faithless refusal to indemnify a director who successfully defends a suit arising from her corporate position. Cf. Restatement (Second) of Agency §438 (requiring principal to indemnify agent whenever agent "suffers a loss which, because of their relation, it is fair that the principal should bear"); *New York Dock Co. v. McCollum*, 16 N.Y.S.2d 844 (Sup. Ct. 1939) (holding directors are not "agents" of corporation and thus not entitled to indemnification as would be the case for employee).

A director's statutory right to mandatory indemnification raises two issues: (1) When is a defense successful? (2) Can there be mandatory indemnification for a partially successful defense?

Success "on the Merits or Otherwise"

Corporate statutes uniformly require indemnification when the defendant is successful "on the merits," such as when the suit is dismissed for lack of evidence or on a finding of nonliability after trial. MBCA §8.52; Del. GCL §145(c). Under most statutes, success can also be on procedural grounds—success "otherwise"—such as when a suit is dismissed because the plaintiff lacks standing or the statute of limitations has run. MBCA §8.52; Del. GCL §145(c). A director, however, is not deemed successful if the claim is settled out of court.

Indemnification “to the Extent” Successful

Some statutes (including some in Delaware) require indemnification “to the extent” the director is successful, compelling the corporation to reimburse a partially successful director’s litigation expenses related to those claims or charges she defends successfully. Del. GCL §145(c).

In *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. 1974), the Delaware Supreme Court interpreted a statute that required indemnification if the director was successful “in defense of any claim, issue or matter therein” as requiring indemnification for partial success. In the case, a director charged with five criminal offenses pleaded “no contest” to one on the condition the others were dropped. The court held he was entitled to indemnification as a matter of right for the litigation expenses related to the charges that were dropped. See also *Waltuch v. ContiCommodity Services, Inc.*, 88 F.3d 87 (2d Cir. 1996) (applying Delaware law to require indemnification of litigation expenses incurred by director charged with conspiring to corner silver market, after company ([but not director]) paid to settle private lawsuits brought by silver traders).

The *Merritt-Chapman* interpretation, it has been argued, permits undeserving directors to negotiate dismissals or plea bargain away most of the claims against them and become entitled to indemnification for the bulk of their litigation expenses. For this reason, some statutes make mandatory indemnification “all or nothing” and limit it to defendants who were “wholly successful.” MBCA §8.52.

§15.1.2 Permissive (Discretionary) Indemnification for Unsuccessful Defense

Indemnification is not automatic when a director becomes liable because of his corporate role. Instead, corporate indemnification of an unsuccessful director’s litigation expenses and liability is discretionary. The corporation may indemnify an unsuccessful director only if indemnification is approved by certain corporate actors or a court, under specified criteria. Under modern statutes the ability of the corporation to indemnify depends on whether the action was brought by a third party or was brought on behalf of the corporation.

Third-Party Actions

In an action brought by a third party—such as when the EPA sues for illegal dumping or investors claim securities fraud—the unsuccessful director must be deserving to be entitled to indemnification.

- **Indemnification criteria.** Many statutes permit corporate indemnification arising from third-party actions only if the director (1) acted in good faith (that is, the director did not know her conduct was illegal and did not act for improper personal gain), and (2) reasonably believed her actions were in the corporation's best interests. MBCA §8.51(a)(1) (or not opposed to corporation's best interests, if director acted in unofficial capacity, such as a representative to a trade association); Del. GCL §145(a). In a criminal proceeding, the director may have had no reasonable cause to believe that her actions were unlawful—a standard that goes beyond good faith. MBCA §8.51(a)(2); Del. GCL §145(a).

  Often the findings implicit in a final court judgment (or administrative order) against a director will be inconsistent with a finding that the director satisfied these criteria. A director increases her chances of permissive indemnification by settling or plea bargaining. Most statutes cooperate and state that a judgment, order, settlement, or no contest plea is not conclusive as to whether the director meets the criteria for indemnification. MBCA §8.51(c); Del. GCL §145(a).
- **Coverage.** A director sued in a third-party action may be indemnified for reasonable litigation expenses and any personal liability arising from a court judgment, an out-of-court settlement, or the imposition of penalties or fines. MBCA §§8.51, 8.50(4), (5); Del. GCL §145(a).
- **Procedures.** Statutes specify who must determine whether a director meets the criteria for permissive indemnification: directors who are not parties to the proceeding, a committee of nonparty directors, independent legal counsel appointed by nonparty directors, or disinterested shareholders. MBCA §8.55(b) (permitting legal counsel to determine if director meets criteria, but not actual amount of indemnification); Del. GCL §145(d). An internal finding that a director is entitled to indemnification is not conclusive, but is subject to judicial review. See *In re Landmark Land Co.*, 76 F.3d 553 (4th Cir. 1996)

(applying California’s indemnification statute to reverse decision by independent directors to indemnify directors because illegal avoidance of federal S&L regulation could not constitute “good faith”).

Actions by or on Behalf of the Corporation

Most statutes do not allow the corporation to indemnify a director “adjudged liable” to the corporation if the action is brought by the corporation itself or by shareholders in a derivative action on behalf of the corporation. MBCA §8.51(d)(1); Del. GCL §145(b). Allowing indemnification would create the absurdity of the corporation receiving payment from a culpable director with one hand and reimbursing the director with the other. This circularity would gut the effectiveness of directorial accountability.

Nonetheless, the corporation can indemnify a director who *settles* a suit brought against her by or on behalf of the corporation for her *litigation expenses* if she meets the criteria for permissive indemnification. MBCA §8.51(d)(1); Del. GCL §145(b) (reasonable expenses indemnifiable if director meets standard of conduct). In addition, a court (as opposed to the corporation) can order indemnification of litigation expenses, if fair and reasonable, even though the director is found liable in a derivative suit. MBCA §8.54(a)(3); Del. GCL §145(b). The MBCA even permits a court to order indemnification of settlement amounts in a derivative suit, if fair and reasonable. MBCA §8.54(a)(3). In each situation, the idea is that well-meaning directors should be protected from the full brunt of their litigation exposure.

Court-Ordered Indemnification

Even if the corporation refuses to (or cannot) indemnify a director under its discretionary authority, some statutes allow a court to order indemnification (of expenses and liability) of an unsuccessful director who the corporation determines does not meet the criteria for permissive indemnification. MBCA §8.54(a). But if the director is adjudged liable to the corporation or is adjudged to have acted for personal gain, the court can only order indemnification of the director’s litigation expenses. MBCA §8.54(a)(3).

§15.1.3 Advancement of Litigation Expenses

The promise of eventual indemnification of litigation expenses after a successful defense may be empty if the director cannot pay for a full defense out of his own pocket. For this reason most statutes allow the corporation to advance litigation expenses during the proceeding. MBCA §8.53; Del. GCL §145(e). When the advances are made, it will not be known whether the director ultimately will be successful or be entitled to permissive indemnification, and the statutes impose varying conditions for advancing expenses. In addition, there is some question under the Sarbanes-Oxley Act whether an advancement of expenses constitutes a prohibited executive loan. Exchange Act §13(k) (see §14.4).

For a director to receive an advancement, the MBCA requires the director to (1) affirm his good-faith belief that he would be entitled to permissive indemnification or indemnification under a charter provision, and (2) undertake to repay the advances if he is not entitled to indemnification. MBCA §8.53(a); cf. Del. GCL §145(e) (requiring only repayment undertaking). Under the MBCA, the corporation acting through disinterested directors or shareholders must then authorize the advancement of expenses, subject to the standards that apply to board action. Official Comment to MBCA §8.53 (board cannot authorize advance if there are "red flags" indicating director not entitled to indemnification); cf. Del. GCL §145(e) (no specification of who must authorize advancement).

Under the MBCA, a director need not give security for his repayment obligation. To avoid discriminatory treatment against directors of modest means, the corporation can accept the repayment obligation "without reference to the [director's] financial ability to make repayment." MBCA §8.53(b). In Delaware two factors are relevant for authorizing advancement: (1) the likelihood the defendant will reimburse the corporation if indemnification is determined to be inappropriate and (2) whether the advancement would serve the interests of the corporation. *Advanced Mining Systems v. Fricke*, 623 A.2d 82 (Del. Ch. 1992).

Advancement is discretionary. The corporation can bind itself by contract (in an agreement, the bylaws, or even the articles) to provide advancement, or can make an advancement on an ad hoc basis. Under the MBCA, a corporation that obligates itself to indemnify a director "to the fullest extent permitted by law" must advance expenses, including in derivative suits, unless the provision specifies a limitation. MBCA §8.58(a). But when the corporation has not bound itself to provide advancement, a corporation's decision not to advance expenses is discretionary and evaluated according to the business judgment rule.

§15.1.4 Exclusivity of Statutory Indemnification

Many statutes make the statutory indemnification provisions and procedures exclusive. Indemnification pursuant to the articles of incorporation, the bylaws, or an agreement is permitted only to the extent consistent with the statute. See MBCA §§8.58(a), 8.59. These statutes require a specific, case-by-case determination that the director is entitled to permissive indemnification or advancement of expenses. Official Comment to MBCA §8.58(a) (compliance with disinterested authorization "still required"). It is not enough that an employment agreement or the articles or bylaws contain a blanket indemnification clause.

Nonetheless, other statutes permit the corporation to indemnify directors under provisions in the bylaws or in a contract even though the statute does not contemplate it. Del. GCL §145(f). The indemnification procedures applicable under these extrastatutory provisions govern, provided they are consistent with "public policy." See *VonFeldt v. Stifel Fin. Corp.*, 1999 Del. Ch. Lexis 131 (interpreting Del. GCL §145(a) to require that director seeking indemnification under bylaw provision has acted in "good faith," though placing burden on corporation to show lack of "good faith"). Among other things, this means that the corporation cannot indemnify a director for liability to the corporation—because of the circularity problem.

§15.2 INSURANCE

Corporate statutes permit the corporation to buy insurance for itself to fund its own indemnification obligations and for directors to fill the gaps in corporate indemnification, principally when a director is liable to the corporation in a derivative suit.

§15.2.1 Insurance Covering Corporation's Obligations

Indemnification is a form of insurance provided by the corporation to its directors, officers, employees, and other agents. The corporation can meet its indemnification obligations, statutory or extrastatutory, either by acting as a self-insurer or by purchasing insurance from outside insurance companies.

§15.2.2 Insurance Covering Liability of Directors and Officers

To supplement indemnification and to cover liability to the corporation, the corporation also can purchase liability insurance for its directors and officers —*D&O insurance*. Premium payments for such policies constitute additional executive compensation and are authorized either as such or by specific statute. MBCA §8.57; Del. GCL §145(g). Many statutes authorize the purchase of insurance even if it covers expenses and liability the corporation could not indemnify. MBCA §8.57; Del. GCL §145(g). Although it might seem anomalous that the corporation can indemnify indirectly through insurance what it is prohibited from indemnifying directly, the theory is that the director herself could have bought insurance, and it should not make any difference that the corporation compensates her by paying the premiums.

Usually, the corporation submits the D&O application and pays the premiums in the name of the insured executives. D&O policies typically cover any liabilities or defense costs arising from the executive's position with the corporation. The policies typically exclude coverage for

- improper personal benefits (such as self-dealing)
- actions in bad faith (including dishonesty)
- illegal compensation
- libel or slander
- knowing violations of law
- bodily injury/property damage
- pollution
- other willful misconduct

Many policies also exclude coverage for fines and penalties (including punitive damages) regardless of the executive's intentions. The effect of the exclusions is to make D&O insurance sometimes less encompassing than indemnification by the corporation.

Examples

1. Jones, a shareholder of Trans Combo Corporation, sues the company's directors for failing to approve a merger for $55 per share with the Harmon Group, at a time the company's stock was trading at $38. Jones brings a derivative suit claiming the board failed to become informed about the Harmon bid and did not negotiate vigorously. Jones seeks damages from the directors. The Trans Combo board appoints a special committee composed of three directors who recently joined the board and Jones did not sue. The committee is authorized to decide all indemnification issues. Assume Trans Combo is incorporated in an MBCA jurisdiction.
   a. The director-defendants consider settling with Jones for $62 million —$5 per share. Must Trans Combo reimburse them for this settlement amount? Can Trans Combo reimburse them?
   b. If the director-defendants settle, must Trans Combo reimburse them for their litigation expenses? Can Trans Combo reimburse them?
   c. The defendant-directors reject the settlement offer, but ask the special committee to advance them money to pay for their mounting defense costs. Can Trans Combo pay the defendants' litigation expenses?
   d. The special committee concludes the directors acted in good faith and with the best interests of the company in mind when they rejected the Harmon bid. The committee nonetheless decides not to advance the directors' litigation expenses. Can it?
   e. The directors go to trial. The court decides the directors violated their duty of care by rejecting the merger without sufficient information, but are not liable for failing to negotiate vigorously. The defendant-directors seek repayment of their expenses related to their successful defense of the disclosure claim. Are they entitled?
2. Eventually, the directors settle with Jones and pay a significant settlement. Trans Combo has a typical directors' and officers' insurance policy with Concord Insurance Company. The policy period covers the claim brought by Jones.
   a. Does the D&O policy cover the settlement payments?

b. Does the D&O policy cover the directors' litigation expenses?

c. Orkin, Trans Combo's CEO, lied to the directors about the worth of the merger, which he wanted to avoid no matter what. Can Orkin seek indemnification under the D&O policy?

3. The Trans Combo directors get a second chance. The Harmon Group again offers $55 a share, and this time the directors accept. Trans Combo merges into New Trans Combo, a Harmon subsidiary. There is no pleasing Jones, who brings a class action in which he claims the directors were uninformed of the company's value, which he says is $65 per share.

a. The directors again want to settle. Must New Trans Combo indemnify them for any settlement amounts? Can New Trans Combo indemnify?

b. The bylaws of Old Trans Combo stated "each director is entitled to indemnification for losses because he is or was a director, if he acted in good faith and with a reasonable belief his conduct was in the best interests of the corporation." Is New Trans Combo obligated to pay for the directors' settlement?

c. New Trans Combo makes significant payments to legal counsel to defend the directors. Must these payments be disclosed?

4. When the Harmon Group approached Trans Combo the first time about a merger, Orkin secretly bought Trans Combo stock on the market. He held on to the stock and eventually realized a hefty premium when the merger finally happened. The SEC sued him for insider trading (see §29.5), but was unable to show liability.

a. Must New Trans Combo pay Orkin's defense costs?

b. If New Trans Combo indemnifies Orkin, can it make a claim under Old Trans Combo's D&O insurance policy?

5. New Trans Combo hires Orkin to run the company. Orkin wants an indemnification agreement before he accepts. Draft one.

Explanations

1. a. Trans Combo is neither required nor permitted to indemnify directors for the amounts they pay in settling a derivative claim. Mandatory indemnification is available only for the expenses related to a successful defense. MBCA §8.52. Permissive indemnification is not available for

amounts in settlement paid by directors. MBCA §8.51(d)(1). Otherwise, the corporation would be collecting from the directors in the suit and repaying them through indemnification, and the deterrent and compensation purposes of derivative litigation would be frustrated. See Official Comment, MBCA §8.51(d) ("permitting indemnification of settlements and judgments in derivative proceedings would give rise to a circularity").

b. Trans Combo is not required, but is permitted, to reimburse litigation expenses in a derivative suit settlement. If the directors settle, they would not have been "wholly successful on the merits or otherwise," and there would be no mandatory indemnification. MBCA §8.52. Nonetheless, the directors may be entitled to indemnification of their litigation expenses—if they meet the statutory standards of conduct. MBCA §8.51(d)(1). Unlike a judgment of liability, a settlement leaves open the factual question of whether the directors acted in good faith and with a reasonable belief they were acting in the best interests of the corporation. See MBCA §8.51(c) (settlement is not determinative director did not meet standard of conduct). This means the corporation, to resolve derivative litigation, may end up paying both the shareholder-plaintiff's expenses (see §18.1.2) and the director-defendants' expenses.

c. Probably. Under MBCA §8.53(a), the corporation may advance a director's litigation expenses if

(1) He affirms his good-faith belief that he is entitled to permissive indemnification under the statutory standard of conduct. That is, that when he rejected the merger he acted in good faith (not dishonestly or with a conflicting interest) and reasonably believing it was in the corporation's best interests.

(2) He undertakes to repay all advances if it turns out he is not entitled to indemnification. Even though some of the directors may never be able to repay these advances, the MBCA permits the committee to accept their undertaking "without reference to financial ability to make repayment." MBCA §8.53(b).

(3) A proper decision-maker determines it knows of nothing that would preclude indemnification. Advancing expenses, like indemnification for liability, is a form of self-dealing. The MBCA requires that any

discretionary decision to pay (or advance) expenses be made by directors (board or committee composed of at least two disinterested directors) or disinterested shareholders. MBCA §8.53(c) (unlike permissive indemnification, independent legal counsel cannot authorize advancement of expenses). If a quorum of the board consisting of nonparty directors cannot be obtained, the board may compose a committee of at least two nonparty directors—the case here. In approving the advance, the committee need not conduct a special investigation that the director would meet the standard of conduct. Official Comment to MBCA §8.53.

d. Yes. The advance of expenses is discretionary, and the corporation is under no statutory obligation. Unless the directors have nonstatutory rights in the corporation's articles or bylaws, or in an indemnification agreement, the statute limits mandatory indemnification to directors who are "wholly successful."

Court-ordered indemnification, however, is available in some situations when the corporation has balked. See MBCA §8.54. The directors would have to show that it is "fair and reasonable" to advance the expenses. For example, the directors might show that the committee was acting out of spite and it was in the corporation's best interests for them to litigate the question of a director's duty to investigate merger proposals. The court can order the corporation to advance expenses even if the director was not entitled to this under the provisions of MBCA §8.53.

e. No. The MBCA requires that the directors be "wholly successful" to be entitled to payment of litigation expenses. MBCA §8.52. Even though the directors were successful in part of their defense, the MBCA seeks to prevent the result in *Merritt-Chapman & Scott Corp. v. Wolfson,* 321 A.2d 138 (Del. 1974), where an undeserving insider accepted criminal liability on one charge for the dismissal of others. Remember, though, that permissive indemnification may be available.

2. a. Yes. Typical D&O coverage extends to suits brought by or on behalf of the corporation. Typically, policies cover the directors for acts or omissions in their capacities as directors or by reason of their status as directors. They exclude coverage for claims of personal profit, deliberate fraud, criminal acts, unauthorized compensation, short-swing

trading profits, or failing to maintain insurance. That is, breaches of a director's duty of care are typically covered.

b. Yes. D&O policies typically cover defense costs. Some policies provide that the insurance company will conduct the defense and require that the insured directors turn over litigation to the insurance company.

c. No. D&O coverage, like nearly all other insurance, excludes coverage for willful, knowing, or fraudulent acts.

3. a. In this example, indemnification is not mandatory, but is permitted. In the merger the surviving corporation assumes all the liabilities of the Old Trans Combo, including any statutory indemnification obligations it would have had. See MBCA §11.07(a)(4).

There is no mandatory indemnification under the MBCA unless the directors are "wholly successful," which they would not be in the case of a settlement. Permissive indemnification, however, is possible in a class action. Here the settlement would be with Old Trans Combo shareholders, not the surviving corporation. New Trans Combo's payment to the directors will have the effect of the Harmon Group paying additional consideration for the merger. There is no problem of circularity.

b. Probably not. The MBCA, unlike Delaware's statute, does not permit extrastatutory indemnification unless it is consistent with the statute. The directors cannot enforce the indemnification bylaw against Old Trans Combo because it did not call for a determination that the directors had met their standard of conduct by a disinterested decision-maker. MBCA §8.51(a).

It might be argued, nonetheless, that because a new set of shareholders (the Harmon Group) will bear the costs of any payments by New Trans Combo, this is not a self-dealing transaction and it would not be inconsistent with the statutory scheme for an *outsider* to reimburse the directors if the directors met the standard of conduct. This argument, curiously, would put the Old Trans Combo directors in the position of having greater indemnification rights after the merger.

c. Yes. The MBCA requires that indemnification payments be disclosed to shareholders in the corporation's annual report. See MBCA §16.21(a). Most corporate statutes (including Delaware's) do not require this disclosure.

4. a. Perhaps. New Trans Combo acquires the indemnification obligations of Old Trans Combo in the merger. See answer 3a above. The MBCA, however, is not entirely clear about whether a company's mandatory indemnification obligations cover defense costs in an insider-trading case.

Mandatory indemnification applies to "any proceeding to which the director [or officer] was a party because he is or was a director [or officer]." MBCA §§8.52, 8.56(c) (officers have same mandatory indemnification rights as directors). Orkin could argue the SEC sued him for misusing inside information that he acquired "because" of his insider position. The statute's provisions on permissive indemnification, which allow indemnification in cases other than "conduct of official capacity," suggest that an insider's indemnification rights extend beyond corporate functions. See MBCA §8.51(a)(2); see also *University Savings Ass'n v. Burnap*, 786 S.W.2d 423 (Tex. App. 1990) (indemnification of director who successfully defended against tipping liability).

Some of the reasons for indemnification argue for finding the statute covers Orkin. Indemnification seeks to align the incentives of directors and officers with the risk-taking preferences of shareholders. So does stock ownership. Directors and officers may be reluctant to acquire shares if their service on the board may expose them to liability if they trade in the company's shares. To encourage share ownership by directors, an indemnification scheme allowing indemnification for trading in those shares makes sense.

b. Perhaps. Unless the D&O policy has a nonassignment clause, its coverage passes to New Trans Combo in the merger. Typically, D&O policies reimburse the company's indemnification of directors' liability or expenses pursuant to statute, contract, charter, or bylaw provision. D&O policies often exclude coverage for claims under §16(b) of the Securities Exchange Act of 1934, the provision for the disgorgement of short-swing profits. See §24.3. That is, insurance does not allow an insider to preserve his illegal trading profits. In this case, however, the director is not claiming a return of profits, and the exclusion would not seem to apply.

5. An indemnification contract might read as follows. Notice that the

agreement calls for the corporation to pay fines, judgments, and settlements without a specific determination by disinterested directors or shareholders, as contemplated by the MBCA. In addition, the agreement does not require that the director seek advancement of expenses by making the good-faith affirmation and undertaking to repay if necessary, also as required by the MBCA. It is possible that a court might read these requirements into the agreement because the agreement is explicitly governed by the MBCA, including its requirements that permissive indemnification and advancement of expenses comply with statutory procedures. See MBCA §8.58(a).

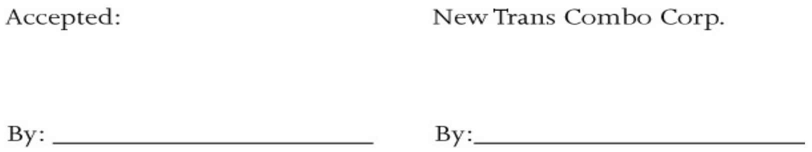
Dear Mr. Orkin:

This confirms the agreement between you and New Trans Combo (Corporation) concerning indemnification.

1. *Indemnification*. The Corporation indemnifies you in your capacity as officer and director (or either) of the Corporation to the fullest extent permitted by law.
2. *Notice*. You will notify the Corporation in writing of any proceeding (whether threatened, pending, or completed) with respect to which the Corporation might be required to provide indemnity. You will provide this written notice within ten (10) business days after first becoming aware that you may be, are, or were a party to such a proceeding. The notice will describe the proceeding and your status in the proceeding and will attach any documents filed in the proceeding. If you fail to provide timely notice, the Corporation will not be obligated to indemnify you with respect to that proceeding.
3. *Defense and advancement of funds*. Unless independent counsel determines that the Corporation is not obligated to provide indemnity, the Corporation will: (a) defend and settle at the Corporation's expense any claims against you in your capacity as officer or director of the Corporation; and (b) pay any fines, judgments, and amounts in settlement in connection with claims against you in your capacity as officer or director of the Corporation. You will cooperate fully in any defense or settlement undertaken by the Corporation. If it is ultimately determined that you are not entitled to indemnity with respect to payments or

expenses (including attorneys’ fees) incurred by the Corporation, then you will reimburse the Corporation for these amounts.

4. *Insurance*. The Corporation will purchase and maintain director and officer liability insurance in the face amount of [typically $1 million] on your behalf under a standard such policy. If at any time after the first year of coverage you conclude that this coverage is inadequate, you will notify the Corporation. If the Corporation does not adjust coverage to your satisfaction, you may request that independent legal counsel (to be paid by the Corporation) review the adequacy of the coverage. Counsel’s evaluation will be binding.
5. *Nonexclusivity and subrogation*. Your rights to indemnification and to advances under this agreement are not exclusive of any other rights to which you may be entitled. To the extent the Corporation has paid amounts under this agreement and you are also entitled to payment from any other person, the Corporation will be subrogated to any claim that you may have for such payment.
6. *Duration, governing law, severability*. This agreement will terminate on the later of (a) ten (10) years after you cease to be a director or officer of the Corporation, or (b) the final disposition of any pending proceeding as to which you have a right of indemnification under this agreement. This agreement is governed by [MBCA jurisdiction] law. The provisions of this agreement are severable. This agreement is binding on and will inure to the benefit of the Corporation’s and your heirs, personal representatives, successors, and assignees.



Accepted: New Trans Combo Corp.

By: ________________________ By:________________________

CHAPTER 16

Corporate Opportunities and Unfair Competition

The duty of corporate managers to put corporate interests ahead of their own personal interests applies not only to dealings with the corporation but also to outside business dealings that affect the corporation. Financial harm to the corporation is just as real when a manager takes a profitable business opportunity from the corporation or sets up a competing business as when the manager enters into an unfair self-dealing transaction with the corporation.

But, just as self-dealing is not automatically void, corporate managers (directors and executives) are not flatly prohibited from taking outside business opportunities. Outside opportunities offer managers a means to diversify their own human capital, and a flat prohibition against outside business activities might well lead many managers to shun the corporate form. The *corporate opportunity doctrine*—a subset of the duty of loyalty—balances the corporation's expansion potential and the managers' entrepreneurial interests.

This chapter describes the corporate opportunity doctrine (§16.1), the definition of "corporate opportunity" (§16.2), the effect of corporate rejection or incapacity (§16.3), and competition with the corporation (§16.4).

§16.1 CORPORATE OPPORTUNITY DOCTRINE

§16.1.1 Prohibition against Usurping Corporate Opportunities

The corporate opportunity doctrine supplies corporate law a deceptively simple rule. A corporate manager (director or executive) cannot usurp corporate opportunities for his own benefit unless the corporation has rejected the opportunity. The plaintiff has the burden of proving the existence of a corporate opportunity.

The doctrine thus raises two issues:

- When does a business opportunity belong to the corporation and thus become a “corporate opportunity”? See §16.2 below.
- When can it be said the corporation has (or would have) rejected the opportunity, thus allowing the director to take it? See §16.3 below.

§16.1.2 Remedies for Usurping a Corporate Opportunity

A director who usurps a corporate opportunity without corporate rejection must share the fruits of the opportunity as though the corporation had originally taken it. Remedies include (1) liability for profits realized by the usurping manager, (2) liability for lost profits and damages suffered by the corporation, and (3) imposition of a constructive trust on the new business or the subject matter of the opportunity (such as land). *Farber v. Servan Land Co.*, 662 F.2d 371 (5th Cir. 1981) (requiring usurper to share profits with corporation after usurper resold business opportunity). Because an outside third party is on the other side of the opportunity, rescission is not available unless the third party had notice of the insider’s wrongdoing.

The corporate opportunity doctrine thus gives the corporation an “option” to take for itself a business opportunity initially taken by a corporate manager. If the opportunity turns out well, the corporation can claim it for itself; if the opportunity flops, the corporation can choose not to pursue its rights.

§16.2 DEFINITION OF "CORPORATE OPPORTUNITY"

What is a corporate opportunity? The courts have articulated and applied a variety of definitions. Underlying these definitions are two conflicting premises:

- **Corporate expansion.** The corporation expects managers to devote themselves to expanding the corporation's business. This maximizes corporate profitability.
- **Manager entrepreneurialism.** Managers expect to have freedom to pursue outside business interests. This promotes entrepreneurial initiative.

It should not surprise you that the courts' attempts to accommodate these inconsistent premises have led to a variety of vague tests, which have evolved over time.

§16.2.1 Use of Diverted Corporate Assets

A fiduciary cannot develop a business opportunity using assets secretly diverted from the corporation. Requiring the fiduciary to share any profits derived from the misbegotten business simply enforces the prohibition against misappropriation.

This analysis is clearest when the assets are "hard" assets — such as when a director uses the corporation's cash, property, or employees to set up a business. In such cases the director is liable whether or not the corporation had an identifiable interest in taking the business opportunity itself and whether or not the business was related to that of the corporation. The real evil is not so much that the director took an opportunity for himself, but rather that he took something that belonged to the corporation to do it. *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939) (use of corporate funds).

Some courts, however, have refused to impose liability on directors who use corporate resources to develop an outside business if the opportunity was one in which the corporation did not have an interest or expectancy. See

Lincoln Stores v. Grant, 34 N.E.2d 704 (Mass. 1941) (refusing to impose constructive trust on competing store that managers set up while still employed by corporation because "company had no interest in or thought of acquiring it").

§16.2.2 Existing Corporate Interest—Expectancy Test

Many courts employ an *expectancy test* to measure the corporation's expansion potential. If the corporation has an existing expectancy in a business opportunity, the manager must seek corporate consent before taking the opportunity.

Corporate expectancies need not rise to the level of an ownership interest. For instance, an expectancy exists if the corporation is negotiating to acquire a new business or an executive learns of a business offer directed to the corporation. See *Thorpe v. CERBO, Inc.*, 676 A.2d 436 (Del. 1996) (finding usurpation when controlling shareholders responded to an outside offer to purchase a corporate subsidiary with a counteroffer to sell the shareholders' controlling interest in the parent). In this regard, the manager's secrecy in taking an opportunity supports a finding of corporate expectancy, on the assumption the manager's concealment suggests the corporation had an interest. Courts have also interpreted the expectancy test to cover opportunities of special or unique importance to the corporation for which there is a presumed expectancy. For example, a corporation's avowed interest in finding a new headquarters site or in acquiring patents necessary for its business fall within the shadow of the corporation's expansion expectancies. See *Northeast Harbor Golf Club, Inc. v. Harris,* 661 A.2d 1146 (Me. 1995) (finding corporate opportunity when country club president acquired for herself property adjacent to club's golf course, which real estate agent had offered to her in capacity as president on assumption club would be interested).

Frequently, expectancies can be shown when the manager misappropriates "soft" assets of the corporation (such as confidential information or goodwill) to develop a new business. On the other hand, if the opportunity came to the manager in his individual (not corporate) capacity, courts are more likely to conclude the opportunity was not corporate. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). It is important to note that the misappropriation of soft assets may also be subject to other prohibitions. For example, a director who uses customer lists or secret manufacturing processes of the corporation in developing his own business may be liable under state statutes prohibiting misappropriation of trade secrets.

§16.2.3 Corporation's Existing Business— Line-of-Business Test

Some courts apply a broad *line-of-business test* to measure the reach of the corporation's expansion potential. See *Guth v. Loft, Inc.,* 5 A.2d 503 (Del. 1939) (opportunity so closely associated with company's activities that it places insider in competition with company). Under the test, courts compare the new business with the corporation's existing operations. The corporation need not have an existing interest or a special need for the opportunity, or the manager need not learn of the opportunity in his corporate capacity. If the new project is functionally related to the corporation's existing or anticipated business, the manager must obtain corporate consent before exploiting it.

Under the line-of-business test a functional relation exists if there is a competitive or synergistic overlap that suggests that the corporation would have been interested in taking the opportunity itself. Consider *Miller v. Miller,* 222 N.W.2d 71 (Minn. 1974). Miller Waste, a closely held family corporation, was in the waste-reprocessing business. Rudolph Miller, one of Miller Waste's managers, developed a patented lubricator for diesel locomotives and set up his own company for their manufacture. Rudolph's company was supplied with waste products produced by Miller Waste's reprocessing business and competed with Miller Waste in the locomotive lubricator market. The court held that a fact finder could have found that Rudolph's business was in Miller Waste's line of business.

§16.2.4 Eclectic Approaches

ALI Principles

The ALI Principles of Corporate Governance lay out a comprehensive approach to corporate opportunities, one which goes beyond the case law. The ALI Principles begin with a definition that combines the narrower expectancy test and a broader line-of-business test. Under the ALI Principles *corporate executives* are subject to line-of-business and expectancy restrictions, while *outside directors* (who have no employment relationship with the corporation) are subject only to expectancy restrictions. See ALI Principles §5.05(b). The difference between corporate insiders and outsiders reflects a view that the corporation is able to demand greater loyalty of corporate insiders than of outsiders.

Fairness Test

Some courts go beyond the expectancy and line-of-business tests, and add (for good measure) an additional malleable fairness test. *Lewis v. Fuqua,* 502 A.2d 962 (Del. Ch. 1985). The fairness test in this context, unlike that for self-dealing, which focuses on the transaction's fairness to the corporation, focuses on the fairness of holding the manager accountable for his outside activities.

Again *Miller v. Miller,* 222 N.W.2d 71 (Minn. 1974), illustrates. Rudolph and Benjamin Miller had exploited a variety of opportunities for themselves that were closely related to Miller Waste's waste-reprocessing business. Rudolph had started a business that manufactured patented lubricators for diesel locomotives using waste filter elements; and together they had set up a packaging business and a plastics business that used waste cotton cuttings. The trial court found that none of the new businesses were within Miller Waste's line of business—a finding that seems factually questionable. On appeal the court, without upsetting the trial court's findings, held in addition that Rudolph's and Benjamin's taking of the new businesses was not unfair to Miller Waste. The new businesses had benefitted Miller Waste by supplying it with a captive market for selling its products; no corporate assets were diverted; there was no secrecy; and Rudolph and Benjamin had continued to work long hours at the waste mill. In the case, the fairness test recognized the managers' entrepreneurial interests and limited the breadth of the line-of-business test.

Service on Multiple Boards

To which corporation does a director owe allegiance when he serves on multiple boards? Courts have shown sensitivity to the dilemma of a director with conflicting duties. For example, consider the situation of Richard F. Broz, an outside director of a cell phone company (Cellular Information

Systems) and owner of his own cell phone company (RFB Cellular). CIS operated in the Midwest and RFB in the Upper Peninsula of Michigan. When a third company decided to sell its cellular license for the eastern tip of the Upper Peninsula, its broker contacted Broz but not CIS. Broz dutifully asked CIs's chief executive whether CIS would be interested in buying the license from the third party, and the CEO declined because CIS was strapped for money. So Broz went ahead on his own.

Soon afterward, CIs's financial fortunes turned when a large firm (PriCellular) agreed to buy the struggling company and inject it with new money. Then, before its purchase of CIS, PriCellular made a bid for the Mackinaw license, but Broz upped his bid and won. Had Broz violated his duties to CIS? Ultimately, the Delaware courts decided he had not. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996) (reversing a decision by Chancellor Allen). The court held that Broz had not taken a corporate opportunity of CIS. First, the court questioned whether CIS had a sufficient expectancy. The third-party license holder had not considered CIS a viable candidate for the license. At the time Broz bought the license CIS was in financial straits and was actually divesting its cellular license holdings. Although PriCellular had promised financial help, it had not yet acquired CIS. Second, the court noted Broz's duties to his own cell phone company, of which CIS was "wholly aware." That is, CIS knew that Broz had another master, which could well come first.

§16.3 CORPORATE REJECTION AND INCAPACITY

Even if a court determines that a business opportunity is a corporate opportunity under the applicable test, the corporation's interest is negated if the corporation either consents to the taking by a corporate manager or was unable to take the opportunity itself. By accepting that managers may engage in outside ventures under some circumstances, the corporate opportunity doctrine recognizes the entrepreneurial interests of managers.

Some courts have folded the question of corporate consent and incapacity into the question of whether the opportunity was a corporate opportunity, for example, placing the burden to show capacity on the corporation. Other cases separate the issues, treating them as defenses to be proved by the enterprising manager. The ALI Principles take the view that the corporation's capacity to take an opportunity is a matter to be decided by the corporation, not a court after the fact.

§16.3.1 Corporate Rejection

The corporation can voluntarily relinquish its interests in a corporate opportunity (for many reasons, such as financing difficulties or risk concerns) by generally renouncing any interest in categories of business opportunities or by rejecting a specific deal. Delaware's corporate statute permits a corporation to "renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in … specified business opportunities or specified classes or categories of business opportunities" presented to the corporation. Del. GCL §122(17); see also MBCA §8.70 (permitting qualified directors or shareholders to disclaim corporation's interest in opportunity).

The corporation's rejection of a specific opportunity, however, may itself be a self-dealing transaction because of the possible conflict between the manager's and the corporation's interests. Some courts subject corporate rejection, like the approval of a self-dealing transaction, to fairness review and require rejection by informed, disinterested directors or shareholders. See *Telxon Corp. v. Meyerson,* 802 A.2d 257 (Del. 2002) (stating that board's informed, considered refusal of corporate opportunity creates safe harbor for interested director). Other courts have held that informal acquiescence to the taking (particularly in closely held corporations) constitutes rejection. Cf. *Farber v. Servan Land Co.*, 662 F.2d 371 (5th Cir. 1981) (finding shareholder inaction did not constitute acquiescence because shareholders relied on usurping insider to investigate business opportunities).

Sometimes courts have folded together the questions of corporate consent and the existence of a corporate opportunity. For example, in *Burg v. Horn,* 380 F.2d 897 (2d Cir. 1967), the part-time managers of a closely held real estate firm acquired other properties with the tacit consent of their co-shareholder. The co-shareholder knew from the start that the managers held and managed other similar properties. Further, the properties acquired by the managers (though in the same line of business as that of the corporation) had not been offered to or sought by the corporation. The co-shareholder's informal acquiescence to the managers' outside entrepreneurialism led the court to conclude they had not usurped a corporate opportunity.

§16.3.2 Corporate Incapacity

Many courts allow managers charged with usurping a corporate opportunity to defend that the corporation could not have taken the opportunity because it was financially incapable or otherwise unable to do so. See *Broz v. Cellular Information Systems, Inc.,* 673 A.2d 148 (Del. 1996) (refusing to find corporate financial capacity when director acquired cell phone license at time cash-strapped corporation was being acquired by another, better-financed company interested in the license). Under this approach, it is not determinative that the manager failed to inform the board. The question of incapacity is left to the court.

If the opportunity was never presented to the board or the shareholders, courts must speculate whether the corporation could have taken the opportunity. This leads to slippery arguments. Even if a manager shows the corporation lacked the funds to take the opportunity itself, it can always be argued that the corporation could have raised the funds by borrowing money or by issuing new stock. After all, the manager had sufficient access to capital to take the opportunity himself, and allowing a manager to later claim corporate incapacity may tempt the manager to not exercise his best efforts to bring the opportunity to the corporation.

Because of the vagaries of these after-the-fact inquiries, some courts have rejected the incapacity defense on the theory that the determination whether the corporation has the financial, legal, and institutional capacity to take the opportunity should be made by informed corporate decision-makers, not the corporate fiduciary. See *Demoulas v. Demoulas Super Markets, Inc.,* 677 N.E.2d 159 (Mass. 1997) (whether out-of-state supermarket chain could legally acquire stores under New Hampshire liquor laws should be decided by informed board, not fiduciary). Delaware, however, has taken the view that formal presentation of an opportunity to disinterested corporate decision-makers is not required. See *Broz v. Cellular Information Systems, Inc.,* 673 A.2d 148 (Del. 1996). Instead, the manager can decide the opportunity is one the corporation is incapable or unwilling to take—though at his risk.

§16.3.3 ALI Principles: Mandatory Disclosure and

Rejection

The ALI Principles assume that the corporation's capacity to take an opportunity is for the corporation to decide, not the manager and later a judge in litigation. The ALI Principles thus take a disclosure-oriented approach that mandates informed corporate rejection before a manager can take a "corporate opportunity." Under this approach, (1) the manager must have offered the opportunity to the corporation and disclosed his conflicting interest, and (2) the board or shareholders must have rejected it. ALI §5.05(a). The manager's failure to offer and disclose the opportunity to the corporation thus creates automatic liability.

If disinterested directors have rejected the opportunity, the board's action is subject to review under the business judgment rule. If rejected by disinterested shareholders, review is under a waste standard. And if the rejection is not disinterested, or the challenger shows waste or a lack of business judgment, the defendant must then prove that the taking was fair to the corporation. ALI §5.05(a), (c).

In *Klinicki v. Lundgren*, 695 P.2d 906 (Or. 1985), the court applied this offer-rejection approach to the president of a closely held air transportation company who secretly took for himself a contract for a new air charter business. The court refused to consider the president's contention that the company lacked the financial ability to undertake the contract because the opportunity had never been presented to the other participant in the corporation. Under the ALI Principles, the offer-rejection "safe harbor" is exclusive.

16.4 COMPETITION WITH THE CORPORATION

Competition with the corporation, although often the usurpation of a corporate opportunity, is subject to special treatment. In general, during their relationship with the corporation, managers may not compete with the corporation unless there is no foreseeable harm caused by the competition or disinterested directors (or shareholders) have authorized it. The prohibition applies whether the competing business is set up during the manager's tenure or was preexisting.

This noncompete duty goes beyond the duties of the corporate opportunity doctrine. A manager with an interest in a competing business that predates his joining the corporation usurps no corporate opportunity, but may be liable in damages for continuing to compete. Further, if the manager does not divert assets in setting up a competing business and if the corporation has no existing interest or need to expand, neither the misappropriation nor the expectancy theory prevents the manager from setting up the competing business.

A manager who violates the noncompete duty may be liable in damages for any competitive losses suffered by the corporation, but the manager need not share the competing business unless setting up the business usurped a corporate opportunity. See *Lincoln Stores v. Grant,* 34 N.E.2d 704 (Mass. 1941) (imposing damages, but no constructive trust, on managers who set up competing store while still employed by corporation).

Other theories of liability may also apply to a manager who competes with the corporation: (1) breach of contractual covenant not to compete, (2) misappropriation of trade secrets (such as customer lists or confidential formulas), or (3) tortious interference with contractual relationships if the manager induces the corporation's customers or employees to follow him.

Examples

1. Atlantis Bottling, Inc., is the authorized bottler of Gusto Cola on the Atlantic seaboard. The corporation is owned and operated by the Garret family. A few years ago, Ruth Garret (Atlantis's founder and largest shareholder) brought her unemployed brother Percy into the business. He is now chief executive officer, and Percy often says, "I owe everything to Ruth." Recently, Percy set up his own chain of dessert shops, which has become highly profitable.
   a. Ruth is distressed and thinks Percy should be forced to share the chain's profits with Atlantis. Percy set up the dessert shops with loans that Atlantis guaranteed under Percy's unauthorized signature. Must Percy share his profits? Under what theory?
   b. As things turn out, Ruth got the facts wrong. Percy set up the dessert shops on his own time and with his own money without using the company's credit. Atlantis had no plans to diversify into the dessert business. Can Percy be forced to share his profits?

c. Ruth points out that from the beginning the Garret family understood "everyone would pitch in and everyone would be taken care of." Does this understanding affect whether Percy must share his profits?

2. Atlantis managers have been considering installing new lighting at the company's dingy bottling plant. Sally Garret (Ruth's niece and supervisor of the plant) has drawn up a new lighting design, which she plans to submit to the board.

   a. Before Sally submits her plan, Percy receives a letter from DustriLite that it is going out of business and is liquidating its industrial lighting inventory. Without telling anyone, Percy uses his own money to buy a boxcar of DustriLite lighting fixtures—cheap! When the board approves Sally's plan, Percy resells the fixtures to Atlantis at the prevailing market price. Must Percy share his profits? Under what theory?

   b. Would it make any difference if Percy had originally disclosed the DustriLite offer to Atlantis's board and the board had at first turned down the offer?

   c. What if DustriLite had sold its inventory to Percy at a discount as a way to express its thanks for his steering Atlantis business to DustriLite. Must Percy share a personal gratuity?

3. Atlantis's sales have fallen recently and some of the company's bank lenders have expressed concern to Percy about the company's ability to repay its outstanding loans.

   a. Percy, swimming in cash because of his successful dessert shops, wants to get the banks off Atlantis's back. He believes that Atlantis's credit is basically sound, and he buys Atlantis's loans from the banks at a deep discount. Can he be forced to share this discount with Atlantis?

   b. Percy believes the banks would not have been willing, on principle, to allow Atlantis to renegotiate its debt. Does this affect Percy's duties?

   c. Percy claims that everyone else at Atlantis knew about the banks' nervousness and did nothing. Does this affect Percy's duties?

4. Ofelia, a nationally known "beverage consultant" and an outside director on Atlantis's board, reads in the newspaper that Tanfa Beverages is going out of business. Tanfa is a bottler of fruit-flavored sodas in California,

and Ofelia calls Tanfa's president, who confirms the company is for sale.

a. Atlantis's board has never discussed expanding outside the Atlantic region, its traditional geographic niche. Ofelia figures Atlantis would not be interested in Tanfa. She wants to buy Tanfa for herself, but without disclosing her plans to Atlantis. Can she?

b. Atlantis's board has lately had extensive discussions about the company's "cash flow difficulties." Ofelia figures Atlantis lacks the funds to buy Tanfa. Does this affect her duties?

c. Ofelia buys Tanfa and convinces Jack Garret (Atlantis's promotional director) to leave Atlantis and work for Tanfa. Do you see any problems?

Explanations

1. a. Yes, under a misappropriation theory. Percy's unauthorized use of Atlantis's credit is as much a diversion of assets as if he had misappropriated money. His wrongful use of corporate resources imposes on him a duty not to take the opportunity whether or not Atlantis had any interest in opening dessert shops itself or whether the shops were related to Atlantis's existing soft drink business.

Some courts, however, would limit Atlantis's recovery to the damages resulting from Percy's unauthorized use of the company's credit. See *Lincoln Stores v. Grant*, 34 N.E.2d 704 (Mass. 1941) (§16.2.1). If so, Percy would be liable for the value of Atlantis's guarantee.

b. Unlikely. Percy's dessert business is not a "corporate opportunity" under any of the definitions applied by the courts.

- Percy did not misappropriate corporate assets in setting up his business.
- There is no indication Atlantis had any plans or need to enter the dessert business. Percy started the business on his own time and presumably with information he derived from outside Atlantis.
- The business opportunity is not within Atlantis's "line of business" because the dessert shops are not functionally related to the bottling business. There is no overlap in raw materials, production, and marketing. Even if Atlantis's charter permitted it and Atlantis had the financial means to expand into dessert shops, the line-of-business

test does not treat every profitable business as within a corporation's expansion potential. In recognition of managers' entrepreneurial interests, the opportunity must be closely related to the company's existing or contemplated business.

- Percy's new business does not compete with Atlantis for customers, suppliers, employees, or assets.

c. Perhaps. Ruth could argue that Percy had a duty to share the opportunity because of the special expectations in this close corporation. The argument parallels the "reasonable expectations" argument that courts have increasingly come to accept in close corporation freezeout cases (see §27.2.1). If the participants in this family business had a "share and share alike" understanding—that a business opportunity available to any of them should be made available to the family corporation—a court might apply broader notions of corporate expectancy and line of business. Moreover, courts have frequently suggested that corporations can expect more of full-time managers (such as CEO Percy) than part-time managers or outside directors.

That is, the corporate opportunity doctrine provides a default rule that the parties have some leeway to contract around. The ALI Principles, for example, permit corporate participants to establish a "standard of the corporation" that permits the taking of specified corporate opportunities without further disinterested approval. ALI Principles §5.09. By the same token the corporation, just as it sometimes obtains noncompete promises, could expand the definition of what constitutes a corporate opportunity. Even if a court were to give significance to the family's "share and share alike" understanding, it should also consider Percy's entrepreneurial desire to diversify his human capital by branching into new businesses.

2. a. Yes, under an expectancy theory. The DustriLite opportunity was an existing expectancy of Atlantis because of Sally's plans for new lighting at the plant. It seems clear that Percy knew about her plans, given his secrecy and prescience to buy the right fixtures. If, for some reason, Percy did not know about the plans or that Atlantis might be interested in the fixtures, his *innocent* taking of a business opportunity would not be the breach of his fiduciary duties.

It makes no difference that the board had not yet approved Sally's plans or that Atlantis's interest was not based on preexisting rights (such as a DustriLite contract with Atlantis). Even though Atlantis could not legally preclude Percy or anyone else from purchasing the fixtures, Atlantis's plans were far enough along to impose on Percy a duty not to take the opportunity without allowing the corporation to consider it.

In these circumstances, a line-of-business theory would not work because buying lighting fixtures is not part of Atlantis's bottling business. The line-of-business test does not compel Percy to get permission to become a lighting-fixture marketer.

You might have noticed also that Atlantis could have sought damages from Percy on a self-dealing theory because he sold the fixtures to the corporation (see §13.1). Although the transaction's price might have been the fair market price, a court could characterize it as procedurally unfair—particularly if Percy failed to disclose how much he stood to profit when he made the sale. In such a case, the self-dealing remedy of rescission would be inadequate; courts have held that damages under a corporate opportunity theory are appropriate.

b. Yes, if the board had also known of Sally's lighting plans. Under most judicial approaches, the rejection of the opportunity by informed, independent, and disinterested directors of the Atlantis board relinquishes the corporation's claim to it, freeing Percy to take it for himself. Not only would Percy have to disclose the terms of the DustriLite offer, but also Sally's lighting plans and his intentions if the board turned down the offer. For the directors to be considered disinterested, they cannot have a financial interest in the lighting fixtures; and for them to be considered independent, Percy cannot dominate their decision-making (§13.3.3).

c. Probably, because the gratuity was for past business with Atlantis, not with Percy. A similar question recently arose in the context of the allocation of IPO shares to corporate directors by an investment bank seeking to foster a relationship with the directors' company. See *In re eBAY, Inc. Shareholders Litigation*, 2004 WL 253521 (Del. Ch. 2004). When the directors turned around and sold the IPO shares for millions of dollars in profits, shareholders brought a derivative suit. Without deciding whether the allocations were a corporate opportunity, the court decided they constituted consideration for continued business with the company, and thus the directors had (at the least) breached their fiduciary duties of loyalty by taking something that belonged to the company.

3. a. Perhaps. Percy's purchase of the debt would mean that Atlantis would owe him 100 percent principal and interest under its loans even though Percy had paid less than 100 percent for these rights. Atlantis could use an expectancy theory to characterize Percy's purchase of its discounted debt as a corporate opportunity and compel Percy to share the profits from his refinancing of the debt. Even if Atlantis had not expressed an interest in restructuring its debt, Atlantis could argue it (like any business) has an ongoing interest in repurchasing its own securities or obligations at a discount because of their "unique value" to the corporation.

On the other hand, Percy could argue that he was simply assuming Atlantis's credit risk from the bank and purchased the debt at market value. There is nothing to indicate Atlantis could have refinanced its debt with a lender other than Percy. It would be unfair to compel Percy to share any gains because his purchase of Atlantis's debt meant only he would bear any losses if Atlantis did not repay on schedule. His argument would be buttressed if Percy, not the banks, initiated the idea of refinancing or repurchase of the debt.

b. Perhaps. If the banks would have been unwilling to sell back their loans to Atlantis at a discount, Atlantis lacked the corporate capacity to take the opportunity itself. Some courts treat corporate capacity as an element of corporate opportunity. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). If Percy could show that the banks would not have dealt with Atlantis, his loan purchase would not be treated as a corporate opportunity. This forces a court to speculate on what might have happened, placing the corporation at a disadvantage to rebut the banks' after-the-fact statements about not giving discounts to borrowers.

Because of this, a modern judicial trend (reflected in the ALI Principles, but rejected in Delaware) is to compel the manager to seek corporate rejection. If the banks are truly unwilling to deal with

Atlantis, the company's disinterested participants presumably would have rejected even attempting the impossible opportunity. Under this approach, Percy would walk a dangerous line by not seeking formal corporate rejection.

c. Perhaps. Percy might be able to characterize the Atlantis inaction as an implied rejection of the opportunity to refinance its debt. Some courts, particularly in cases involving closely held corporations, have treated acquiescence as rejection of an opportunity.

Nonetheless, the approach of other courts, and of the ALI Principles, is to avoid speculation about corporate capacity. Under the ALI Principles, for example, the opportunity must be offered to the corporation and rejected by the board or shareholders. ALI Principles §5.05(a)(2). To meet the standards of the business judgment rule, the ALI Principles imply that rejection by the board must be by formal action; shareholder action must be taken at a meeting. This approach may not make much sense in a close corporation, such as Atlantis, where the corporate participants may act casually without corporate formalities.

4. a. Perhaps not. The Tanfa opportunity may be an opportunity within Atlantis's line-of-business expansion potential, but not necessarily one that outside director Ofelia must disclose or share. Although Atlantis has no present plans to expand into the West Coast market, the line-of-business test does not depend on actual expectancies. Tanfa is in the same business as Atlantis, though the two bottlers do not sell in the same markets. Atlantis's acquisition of Tanfa would create new opportunities for expanding Atlantis's existing business. It would provide new products for Atlantis's current markets and open a new market for its existing products.

Some courts, however, would consider Ofelia's position as a nonexecutive outside director. Her entrepreneurial interests are presumably greater because she is not an employee of Atlantis, and her outside status diminishes the corporation's expectations in her exclusive loyalty. Under the ALI Principles, for example, a line-of-business opportunity is not considered a "corporate opportunity" when an outside director learns of it in a noncorporate capacity. See ALI Principles §5.05(b).

b. Perhaps. If the opportunity were considered a corporate opportunity for Atlantis, Ofelia's incapacity defense depends on whether a court would require the board to make the call (after disclosure by Ofelia) or whether the court would decide the issue on its own. Some courts, particularly in Delaware, allow the defense even though the opportunity was never presented to the corporation. The burden of proving financial incapacity is difficult. Ofelia will have to show Atlantis could not have raised the money through new debt or equity financing. The argument that financing was unavailable will ring hollow because Ofelia seems able herself to afford the acquisition.

Some courts, and the ALI Principles, have rejected the incapacity defense. Under their approach, corporate incapacity must be decided by fully informed, disinterested directors or shareholders. If the Tanfa opportunity were a corporate opportunity for Atlantis, the board would have to reject it. Under this approach, however, Ofelia need not offer to lend money to the corporation so it can make the acquisition.

c. Yes, on three possible grounds.

First, whether or not the acquisition of Tanfa is a corporate opportunity, Jack's continued employment with Atlantis might itself be seen as an opportunity. Atlantis could argue it has an expectancy that Jack will stay with Atlantis (particularly if he is under contract or is subject to a covenant not to compete) and that his services have special value to Atlantis. By hiring him away, Ofelia has usurped a corporate opportunity.

Second, Tanfa is now competing with Atlantis, and Ofelia (as a fiduciary of Atlantis) is under a broad duty not to harm Atlantis competitively. (Notice that this may conflict with her duties to Tanfa and force her to cut her ties to one or the other. Ofelia can compete with Atlantis after she resigns from her board position.)

Third, if Jack is under contract and particularly if he is subject to a noncompete covenant, Ofelia may have tortiously interfered with Atlantis's contractual relationship by wooing Jack away.

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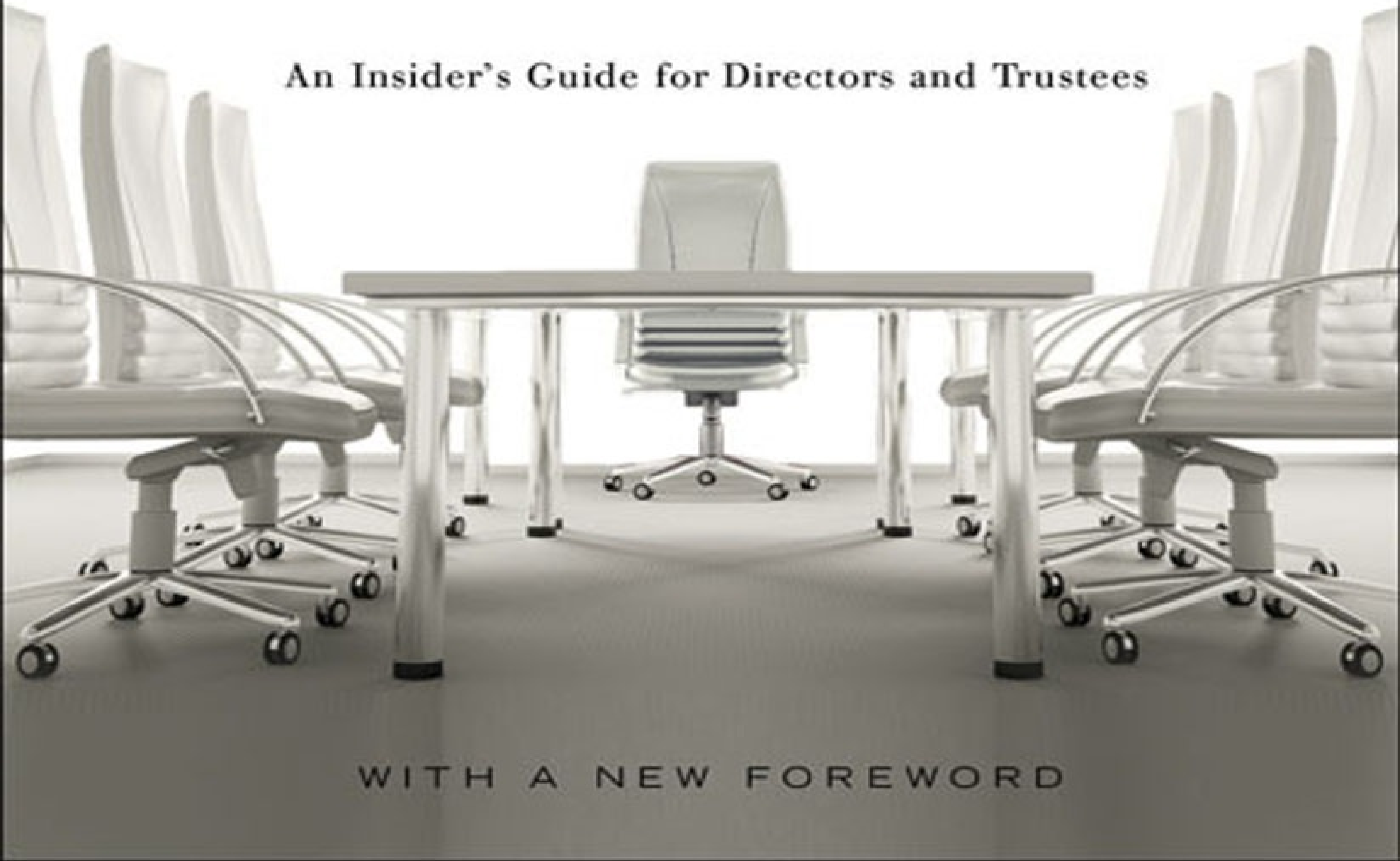
WILLIAM G. BOWEN

THE BOARD BOOK

An Insider's Guide for Directors and Trustees



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AN INSIDER'S GUIDE FOR DIRECTORS AND TRUSTEES

William G. Bowen

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To the colleagues
with whom I have served on boards—
and from whom
I have learned so much

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The Board Book

Foreword to the Paperback Edition

William G. Bowen
June 22, 2011

As I continue to hear from readers, I am gratified that the basic propositions in *The Board Book* seem as valid today as they did when the book first appeared some four years ago. But there have been major changes in the context within which both for-profit and nonprofit boards operate. As a result, some new emphases are in order.

Without question, the fiscal stresses and strains resulting from the subprime meltdown and the ensuing recession have affected life in almost every boardroom, albeit in different ways depending on whether one serves on the board of a financial services company in the for-profit sector or a hard-pressed university or foundation in the nonprofit sector. However, before discussing these differences, I want to note one important commonality. As the stakes have risen, boards of all kinds must recognize the need to constantly reinvent themselves and recruit highly talented new members. Building strong boards has never been more important.

In watching this process at close range, I am now even more persuaded than I was earlier of the importance of confronting weaknesses directly, pruning boards when necessary, and adding individuals of extraordinary ability. A simple lesson worth reiterating is that excellence attracts excellence. Directors and trustees need to enjoy coming to meetings, and enjoyment is often the product of stimulation and active exchanges with bright colleagues. When I recently dropped a note to a new board member of a nonprofit on which I serve, congratulating him on his contributions at the last board meeting and telling him how fortunate we are to have him, he responded, “I am enjoying my experience and especially the fine company of brilliance around the table.”

In the For-Profit World

A common theme in books and articles about the widespread financial perturbations resulting from the bursting of the housing bubble is that not nearly enough attention was paid to risk. The boards of a number of entities seem not to have understood the implications of complicated new financial instruments and to have allowed far too much leverage. Both the rating agencies and regulators failed to exercise proper oversight.

In retrospect, it is clear that more time and attention should have been given to analyzing risk profiles. One implication is that board committee structures and board agendas—especially but not only in the financial services sector—need to provide for regular and rigorous review of risk factors. Management must of course work closely with boards in this process and be entirely open in highlighting (not just presenting) all the relevant facts. But boards also have to avoid becoming too "accepting" of whatever management tells them. Some real independence is required, and strong leadership of the board—either in the form of a separate chairman or in the form of an able lead director—is an essential safeguard. One theme of this book is the need for a mutually respectful partnership between the CEO and the board leader. The events of the last few years provide even more reason to emphasize the importance of getting this relationship right.

Ethical issues have also become more and more prominent. The insider-trading cases are the most visible manifestation of a culture that at times seems oblivious to ordinary notions of fair dealing. Companies as well as individuals cannot afford reputational risk, and boards have a role to play in asking the tough questions and making sure that they are honoring the spirit as well as the letter of the law.

It is now more evident than ever that "courage and the will to act" are always needed.

In Colleges and Universities

Trustees of colleges and universities often act as if the wolf is at the door, but today a combination of factors—sharp losses in the value of endowments, severe cutbacks in public funding, and growing resistance to tuition increases—justify real worries in many situations. An irony is that these financial pressures have peaked at just the time when the country's political leaders are calling on higher education to raise levels of educational attainment across the board. It is now understood that the United States cannot simply take for granted its presumed position as the country with the best educational system in a world in which competition is increasingly a "brain game."

To be sure, some privileged places are much less subject to these cross-pressures than are others. But complacency is dangerous everywhere and all the time. From the standpoint of board responsibilities, this combination of circumstances increases the emphasis that should be placed on strategic planning. It is always tempting to play for time, by imposing across-the-board cuts in budgets, for example. If difficulties are thought to be temporary, with sunny skies expected soon, this approach can make sense. If, however, there are reasons to believe that something fundamental has changed, then it is much wiser to rethink big questions, such as how to deliver instructional services. And it is my view that the forces that have led to such severe fiscal strains, especially on public colleges and universities, are anything but transitory. Strains on state budgets are a result of deep-seated fiscal dislocations, and there is no denying either the public's resistance to tax increases or the pressures of competing priorities, such as paying for health care and meeting pension obligations. I do not think it is realistic to believe that great state university systems, such as California's, will ever again benefit from the level of state appropriations that they enjoyed in earlier days. If this prognosis is right, major decisions have to be made.

The consequences for governance could be profound. We already see signs of serious tensions between legislators/regents on the one hand, and faculty on the other hand—with presidents and senior administrators caught somewhere in the middle. In quiet times, there was no need to press the issue of where responsibility for decisions about teaching methods rested. The usual assumption was that faculty members made all such decisions, albeit within some rough budget parameters set by others. Now, however, serious consideration has to be given to far-ranging proposals to adopt some version of online learning, to take that example. I am now involved in a study of whether the use of truly interactive online learning pedagogies in fields like basic statistics can both improve learning outcomes and reduce costs—in short, raise "productivity" (a word that too often raises hackles in academic communities). To be sure, this is not an either-or question, since there is much to be said for hybrid approaches in which faculty members work with an interactive system to deliver instruction. Still, the “adoption” question is real, and right before us: who decides what approach to adopt, how the benefits of the new approach are to be shared, and what the implications are for enrollment and staffing?

Boards of trustees and regents need to think carefully about their overarching responsibility for seeing that their institutions function well in meeting educational needs. At the same time, trustees and regents need to respect the faculty’s proper concern for maintaining educational quality and certifying academic achievement. The best approach is not, I think, for trustees/regents to say simply, “This is my territory, that is yours.” Rather, there is much to be said for a collaborative approach in which the legitimate interests of all stake-holders are respected. Creating such a collaborative mode of decision making, aimed at aligning incentives, is a real challenge. Few if any good models exist today. Presidents and administrators plainly need to lead such strategic planning and to be open themselves to some new ways of operating. But they have to have the support and assistance of their governing boards—and the understanding of faculty leaders.

In Foundations and the Philanthropic Community

These same seismic shifts in financial pressures have implications for those charged with setting directions for foundations and the philanthropic community. There are two points to emphasize. First, as in the case of colleges and universities, it is important to take the long view and resist temptations to find a quick “fix.” Second, it is vital that new initiatives not just be started and then abandoned, but that hard thought be given to sustainability. Here again, governing challenges are real, since it will often be wise to blend infusions of philanthropic dollars with other sources of funding, including user fees. “Donor fatigue” is both common and understandable, and it is unwise for the boards of either foundations or recipients of foundation largesse to assume that start-up funding will last forever.

NOTWITHSTANDING THESE MAJOR changes in the context within which boards must function in three rather different sectors, the basic principles of good governance have not changed. These principles need to be applied, however, against the backdrop of rapidly shifting fiscal and political realities. Boards that follow a rigid “business-as-usual” approach are likely to produce poor results. In today’s turbulent times, careful attention to reinvigorating board structures and policies, along the lines suggested in the pages that follow, is more important than ever before.

Preface

BOARDS OF directors and trustees matter greatly. That simple truism is understood far better today than ever before. The full effects of “good” versus “bad” governance can be hard to calibrate and are the subject of active debate, but no one doubts that they are real. When things go wrong at major corporations such as General Motors (never mind Enron), there are serious consequences for society at large, as well as for the workers, investors, and communities directly involved. The directors are accountable to these various constituencies, and it is up to them to ask probing questions about the organization’s strategic directions as well as the quality of leadership and, if need be, to replace the CEO or recommend other managerial changes. In the nonprofit sector, too, the media are increasingly critical of boards that seem to be “snoring” while performance deteriorates.[1] Boards of directors and trustees are, after all, the steering devices for complex organizations—with the potential to guide them down right or wrong paths. Their job is by no means only to help organizations avoid serious missteps; they also need to be proactive partners in working with the CEO/president to achieve highly positive outcomes.

Any reader of the daily press knows that interest in corporate governance has increased in recent years—a phenomenon fueled in part by widely publicized scandals and ever-increasing shareholder activism.[2] The business sections of leading newspapers have become as full of drama, and of dramatic revelations, as the sports pages. At the same time, good performance tends to go unnoticed—an aggravating but inevitable asymmetry. The widely publicized instances of foolishness, if not outright bad behavior, have led commentators in the media and institutional shareholders alike to demand that boards open themselves to ideas from outside the boardroom, and even change their structures and habitual forms of operating.

Yet, though the explosion of interest in board governance is undeniable, how boards actually work remains mysterious to many people, including many of those elected to serve on boards. Where power resides, how it is distributed and exercised, and how it is limited and controlled often remain obscure. This black-box perception of boards is a serious problem in and of itself, because all of us have a stake in the effective functioning of organizations that affect our lives and our society in so many ways.

Approach Taken

It was more than a dozen years ago, in 1994, that I published my first book on the workings of boards of directors and trustees in both the for-profit and nonprofit sectors (*Inside the Boardroom: Governance by Directors and Trustees*). In the intervening years I have seen some of the propositions that I outlined then tested in real-time situations. I have also learned new lessons from my participation on the boards of corporations such as American Express and Merck, as well as through active involvement in the governance of TIAA-CREF and the Mellon Foundation in the nonprofit sector. In addition, I have continued to benefit from the experiences, insights, and candid comments of friends who have served on many other boards, including those of such radically different entities as WorldCom, Enron, the Smithsonian Institution, and Harvard.

Much has changed over this period—but certainly not everything. Governance remains a fascinating subject. At bottom, it has to do with power and accountability—with who exercises power, on behalf of whom, and how the exercise of power is controlled.[3] It involves complex webs of personal as well as institutional relationships. It provides the voyeur with insights into human frailties at the same time that it provides the student of abstract organizational structures with conundrums. Governance also *seems* to be a relatively accessible subject. As one highly experienced board member, John C. Whitehead, puts it, “When it comes to governance, everyone is an expert.”

One of the most important current topics in the for-profit sector is the ever-evolving relationship between boards and their CEOs. In the mid-1990s some corporations had begun to consider having a non-executive chairman or a “lead director,” but this topic commanded not nearly as much attention then as it does today. Lead directors are found frequently now in the for-profit sector (especially at large companies), and some well-informed students of corporate governance have said privately that they have had something of a conversion when it comes to what many consider the more radical option of separating entirely the role of CEO from the role of chairman. I am skeptical that there is any one “right” model for all situations, and one of my principal objectives in this study is to parse out in some detail the pros and cons of different approaches before suggesting when one model or another is most appropriate. This book, then, is about CEOs as well as boards, and how to structure the most effective partnerships between them.

The Board Book: An Insider’s Guide for Directors and Trustees pays close attention to nonprofit organizations as well as to for-profits. I am interested in boards of trustees as well as boards of directors. Of course, there is a wide variety of types of organizations within each of the two broadly defined sectors: Although useful for many purposes, for-profit versus nonprofit is often too gross a classification system. At the minimum, we must distinguish for-profit companies that are publicly owned from the increasing number of for-profit companies that are privately held. In addition, small start-ups are very different from large, multinational companies.

In the nonprofit sector, charitable nonprofits (which are eligible to receive tax-deductible contributions) need to be distinguished from other nonprofits, such as labor unions and trade associations. Within the charitable group, it is important to distinguish service providers and grant seekers from grant makers (foundations). Charitable nonprofits differ according to their size, their dependence on earned income, their entrepreneurial characteristics, and their respective missions. Museums are very different from civil rights organizations, which in turn differ in fundamental ways from hospitals, environmental entities, and colleges.

Many other distinctions could be introduced within both sectors, but in this book I focus primarily on (1) large, publicly owned and widely traded for-profit corporations; and (2) service-providing, grant-seeking nonprofits, including colleges and universities. I will, however, also comment on governance within the growing private-equity part of the for-profit sector and within grant-making foundations when there are instructive comparisons to be made.

My own fascination with how boards function is long-standing and dates back to the late 1960s, when I was much involved in efforts to think through the governance of universities in the aftermath of Vietnam War protests and other campus controversies.[4] My thinking about corporate governance issues can be attributed originally to the takeover movement in the 1990s, the rise of the institutional investor, and the appearance in the business world of the "Watergate style" of investigative reporting.

Subsequently, a series of rather gripping personal experiences intensified my interest in for-profit companies. For whatever reasons (my wife thinks I am a virus, and that wherever I go there is trouble!), I have been a direct participant in some highly charged events. These have included the takeover of NCR by AT&T, the resignation of James Robinson as CEO at American Express, the sale of Rockefeller Center to a Japanese company, the forced change in leadership of the Reader's Digest Association, and, most recently, the election of a new CEO at Merck and the legal challenges associated with Merck's voluntary withdrawal of VIOXX from the market. Anne Armstrong, a colleague on the American Express board and on the Smithsonian board of regents, observed that it was her participation in several "revolutions" that had caused her to reflect on the topic of governance. My own sequence of experiencing and thinking is the same as Ms. Armstrong's.

My tenure as president of the Andrew W. Mellon Foundation from 1988 until July of 2006 gave me the opportunity to learn about the daunting challenges that face boards in both the foundation world and the nonprofit sector in general. The workings of the board of the Mellon Foundation gave me new insights into how such boards can stimulate and even inspire new approaches. But interactions with potential grantees also provided examples of problematic board performance—it was distressing to see opportunities missed and resources wasted.

My own mix of experiences in the for-profit and nonprofit sectors has led to one of the distinguishing characteristics of this book: its comparative approach. I am convinced that we can learn much by contrasting presumptions and practices in the two sectors, and there is more than a little room for improved performance all around. Contrary to general impressions, nonprofit boards are sometimes better positioned than many of their corporate cousins to deal with recurring problems faced by all boards, including achievement of the optimal relationship between the board and the CEO. Nonprofit boards, in turn, have much to learn from disciplines characteristic of corporate boards—especially the routine use of benchmark data and the constant monitoring of discrepancies between planned outcomes and actual results.

Although this comparative orientation is not the usual approach, I believe that some of the most vexing questions are seen in a new light when a conscious effort is made to understand why different models predominate in one sector or the other. An apt analogy is foreign travel. When I visited the People's Republic of China in 1974, shortly after the Cultural Revolution, I came back not only with a new awareness of the problems and opportunities facing that vast country, whose history and culture are so different from our own, but also with a heightened sense of what was special about the United States and its institutions. Today, countries like China, India, and Russia (as well as the developing world in general) have a great need for more effective governance of their evolving corporate sectors, since the risks of investing in such countries are compounded by concerns about accountability and oversight. As the United States seeks to improve its own governing mechanisms, it would be splendid if the best features of board governance in this country could be "exported" in appropriate ways. Comparative approaches can—and should—lead to knowledge transfers in all directions.

In writing this book, I make no claim to having made a full scholarly review of a considerable, rapidly growing body of literature.[5] Nor have I conducted new empirical research. As I have already indicated, the raw material underlying the text consists primarily of a combination of lessons that I learned while serving on a variety of boards and extensive discussions with others who have served in similar capacities. In commenting on these experiences (mine and those of other people), I do not attempt to repress a personal tone.[*]

I have also felt no reluctance to present normative propositions, although in this book I have avoided proposing specific norms, in part because I have wanted to avoid sounding preachy. In addition, I am increasingly aware that there are exceptions to almost every rule, and that it is dangerous to be too formulaic. Still, in discussing many topics, I am prescriptive. For example, I feel strongly that it is unwise for a former president or CEO to stay on the board of an organization that he or she once led. Similarly, I am an advocate of mandatory retirement. My allegiance to these general propositions is clear; however, several commentators have made me aware of special situations in which it can make sense to set aside these strong presumptions. Accordingly, my approach has been to state what I believe the general rule should be and then to identify, as best I can, the high hurdles to be cleared in order to justify taking another approach.

Personal experiences (especially when they are gripping) can help one see simple points with unusual clarity, but they can also lead to erroneous generalizations—which is a principal reason why I have been helped so much by criticisms and suggestions offered in response to drafts of this manuscript. In working and reworking this material, and in reviewing and discussing the comments of others, I have become increasingly aware of how autobiographical many of us are when we discuss governance. What has worked, or failed to work, for each of us in our own settings takes on a special aura.

In the spirit of full disclosure, the reader should know the associations that have informed many of the comments that follow—and, by inference, the kinds of experiences that I have *not* had, since I am as conscious of the deficiencies of my preparation as I am of the rich array of opportunities I have had to learn at first hand about governance.

At one time or another I have served as an outside director of five for-profit corporations: American Express, Merck, NCR (until its acquisition by AT&T), Reader's Digest, and the Rockefeller Group. I have not served on the boards of small for-profit start-ups, and I cannot speak from first-hand experience about the burgeoning private-equity world—though I do feel that I know enough about developments in this sector to comment about their general implications for governance.

In the nonprofit sector, I have served as an outside director of six entities: the Center for Advanced Study in the Behavioral Sciences, Denison University, the Public Broadcast Laboratory of National Educational Television, the Sloan Foundation, the Smithsonian Institution, and the Wallace-Reader's Digest Funds. In addition, as president (CEO) I have served ex officio on the boards of Princeton University and the Andrew W. Mellon Foundation. As a result of Mellon Foundation initiatives in the field of digital technology, I have also served (and continue to serve) on the boards of three independent nonprofit spin-offs: JSTOR, ARTstor, and Ithaka.[6] Furthermore, in part as a consequence of the Mellon Foundation's larger interest in the health of the nonprofit sector, I am familiar with organizations as diverse as the American Antiquarian Society, the Barnes Foundation, the New York Botanical Garden, the Population Council, the New-York Historical Society, Duke and Harvard universities, and the Martha Graham Dance Company.

In the course of writing this book, I have benefited enormously from access to a special resource: numerous colleagues and friends who took the time to comment, often at length, on the topics discussed here. Many of their observations were so perceptive, and so well stated, that I have incorporated them directly into the text, with or without attribution as seems appropriate. What started out as personal impressions evolved into an unusual kind of collaborative work, with layers of commentary, and occasionally comments on the commentary, interspersed through the text. In this regard, if in no other, the final product has a kind of Talmudic character. Kevin Guthrie, founding president of JSTOR and now president of Ithaka, has reminded me that, in this regard, my work product resembles a book project initiated at MIT called "We is smarter than me."

The active involvement of so many sharp-eyed and sharp-tongued commentators in the construction of this manuscript, along with the interactive character of much of the text, has become a distinguishing characteristic of the book. Because of the importance that I attach to the contributions of the commentators, I list them here, with some of their principal affiliations. In the text, I provide brief identifications of commentators when I first cite their views, but I hope that readers interested in knowing more about the individual commentators will return to the fuller list of their affiliations provided here. Some of these individuals commented on only the draft of this book, others commented on both this book and its predecessor, and still others commented on only the first book.

Commentators

The Honorable ANNE L. ARMSTRONG, executive committee chairman of the Center for Strategic & International Studies; former ambassador to the Court of St. James's

BRUCE ATWATER JR., former chairman and CEO of General Mills

ROBERT L. BANSE (deceased), former senior vice president and general counsel of Merck & Co.

LEWIS BERNARD, chairman of Classroom, Inc.; advisory director of Morgan Stanley

HENRY S. BIENEN, president of Northwestern University

JOHN BIGGS, former chairman and CEO of TIAA-CREF

W. MICHAEL BLUMENTHAL, president of Blumenthal Partners; former partner at Lazard Frères & Co.; former chairman and CEO of Unisys; former secretary of the treasury

DEREK BOK, former president of Harvard University

FREDERICK BORSCH, professor of New Testament and chair of Anglican studies at the Lutheran Theological Seminary at Philadelphia; former bishop of the Episcopal Diocese of Los Angeles

LARRY BOSSIDY, former chairman and CEO of AlliedSignal; former chairman and CEO of Minneapolis-Honeywell

JEFFREY BRINCK, former partner of Milbank, Tweed, Hadley & McCloy; CEO of TIPHYS Fiduciary Enterprises and of Poseidon Services Inc

McGEORGE BUNDY (deceased), former president of the Ford Foundation; former national security advisor

GLENDA BURKHART, former senior vice president of the Reader's Digest Association; chairman of the Women's Commission for Refugee Women & Children

DAVID M. CULVER, chairman of CAI Capital Corporation; former chairman and CEO of Alcan Aluminium

D. RONALD DANIEL, former treasurer of Harvard University; former managing director of McKinsey & Company

RALPH D. DENUNZIO, former chairman and CEO of Kidder, Peabody Group, Inc.

NICHOLAS DONATIELLO, president and CEO of Odyssey Ventures

CHARLES W. DUNCAN JR., investor; former secretary of energy

CHARLES E. EXLEY JR., former chairman and CEO of NCR

RICHARD B. FISHER (deceased), former chairman of Morgan Stanley

KENNETH C. FRAZIER, executive vice president and president, global human health, Merck & Co.

RICHARD M. FURLAUD, former chairman and CEO of the Squibb Corporation

Ellen Futter, president of the American Museum of Natural History; former president of Barnard College

Louis V. Gerstner Jr., chairman of the Carlyle Group; former chairman and CEO of IBM; former chairman and CEO of RJR Nabisco

Robert Goheen, president emeritus of Princeton University

William T. Golden (deceased), corporate director; trustee

Harvey Golub, chairman of the board of Campbell Soup Company; former chairman and CEO of American Express

Hanna Holburn Gray, president emeritus of the University of Chicago

George V. Grune, former chairman and CEO of the Reader's Digest Association

Kevin Guthrie, president of Ithaka

John M. Harris, former president and CEO of Rockefeller Financial Services

Robert Kasdin, senior executive vice president of Columbia University; former treasurer and chief investment officer of the Metropolitan Museum of Art

Nicholas Katzenbach, former senior vice president and general counsel of IBM; former US attorney general; former undersecretary of state

Frederick J. Kelly, former dean of the Stillman School of Business of Seton Hall University

John C. Kenefick, retired chairman and CEO of the Union Pacific Railroad

Donald S. Lamm, former president and CEO of W. W. Norton & Company

Richard Lyman, former president of the Rockefeller Foundation; former president of Stanford University

Edgar M. Masinter, retired partner of Simpson Thacher & Bartlett

Robert McCabe, president and CEO of Pilot Capital

Mary Pat McPherson, president of the American Philosophical Society; former president of Bryn Mawr College; former vice president of the

Andrew W. Mellon Foundation

Michael S. McPherson, president of the Spencer Foundation

Arjay Miller, former dean of the Stanford University Graduate School of Business; former president of the Ford Motor Company

Thomas Neff, chairman of Spencer Stuart U.S.

Stephen P. Norman, secretary of American Express

Stephen Oxman, advisory director of Morgan Stanley; chairman of the executive committee of the Princeton University board of trustees

Louise Parent, executive vice president and general counsel of American Express

Alan Pifer (deceased), former president of the Carnegie Corporation and the Carnegie Foundation for the Advancement of Teaching

Frank Popoff, former chairman and CEO of the Dow Chemical Company; former chairman of Chemical Financial Corporation

W. Taylor Reveley III, dean of the Marshall-Wythe School of Law at the College of William & Mary; former partner at Hunton & Williams

Frank H. T. Rhodes, president emeritus of Cornell University

Barbara Paul Robinson, partner of Debevoise & Plimpton

Neil L. Rudenstine, chairman of ARTstor; former president of Harvard University

Harold Shapiro, president emeritus of Princeton University

James Shulman, executive director of ARTstor

Dennis T. Sullivan, president and CEO of the Church Pension Group, Episcopal Church of America

Samuel O. Thier, MD, professor of medicine and health care policy at Harvard University; former president of Massachusetts General Hospital

Franklin A. Thomas, former president and CEO of the Ford Foundation

SARAH TURNER, associate professor of education and economics at the University of Virginia

MICHELE S. WARMAN, general counsel and secretary of the Andrew W. Mellon Foundation

RAWLEIGH WARNER JR., former chairman and CEO of Mobil Corporation

SIR DENNIS WEATHERSTONE, former CEO and chairman of JPMorgan

CLIFTON WHARTON JR., former chairman and CEO of TIAA-CREF

JOHN C. WHITEHEAD, former deputy secretary of state; former senior partner and co-chairman of Goldman Sachs

HERBERT S. WINOKUR JR., chairman and CEO of Capricorn Holdings; former chairman of the finance committee of the board of directors of Enron

EZRA ZILKHA, investor; corporate director and trustee

HARRIET ZUCKERMAN, senior vice president of the Andrew W. Mellon Foundation; professor emerita of Columbia University

Organization

Chapter 1 begins by posing what is almost the primordial question: Why do we have boards at all? I examine the principal functions of boards of directors and trustees, their similarities and differences across the for-profit and nonprofit sectors, and the extent to which changes in the general business–social–political environment have altered both the issues facing boards and the behavior of boards. Finally, I consider two questions not addressed often enough: the extent to which external constraints preordain outcomes, regardless of what boards do or don’t do, and whether these external checks are more significant in for-profit than in nonprofit settings.

Chapter 2 deals with the question of leadership—specifically the relationship between the board and the CEO of an organization. I call attention to the increasing number of “lead directors,” “presiding directors,” and “non-executive chairs” in corporate America and attempt to explain the factors driving this trend. I start from the premise that the days of the imperial CEO are (and should be) over. I then argue, at the conceptual level, in favor of separating the roles of CEO and chairman before identifying practical considerations that may favor maintaining the combined chairman–CEO model or adopting the lead director approach, especially as a transitional model.

Chapter 3 focuses on the increasingly lively topic of CEO compensation (as illustrated by the challenge posed to compensation committees by no less a figure than the president of the United States, “to pay attention to the executive compensation packages that you approve”).[7] I suggest ways in which corporate compensation committees can exercise greater independence and enjoy more success in linking pay to performance. In the nonprofit sector, the compensation (and benefits) of presidents and executive directors has also become much more actively debated, but here I argue that compensation is often inadequate rather than overly generous. Trustees do need to be careful, however, to exercise properly their important oversight function—especially in regard to “perks.”

Chapter 4 discusses the marked increase in terminations of CEOs, especially in the corporate sector, and the kinds of evaluation processes that a board needs to have in place in order to decide when to make a change in the leadership of the organization. I discuss specific examples—in the nonprofit sector as well as in the for-profit sector. One question that cuts across sectors is whether the length of “the leash” given to CEOs should differ for nonprofits and for-profits.

Chapter 5 covers CEO transitions, and the first topic discussed is succession planning—a function that badly needs improvement. How the search process itself is conducted is an enormously important subject in both sectors, and there are certainly lessons to be learned from recent experiences in recruiting new CEOs and new presidents. One central question is the role of search firms, and another concerns the criteria that should be emphasized in looking for a new leader. I also address the need for “graceful” exits of departing chief executives, and how to ensure that new leaders have full opportunity to chart their own paths.

Chapter 6 discusses building the board, which is seen increasingly—and properly—as an ongoing developmental process in both the for-profit and nonprofit sectors. Size itself matters, and characteristic sizes of boards differ in the two sectors, for reasons that will be made clear. Nonprofit boards are, nonetheless, often too large to be effective. Fortunately, the process of recruiting new board members has become much more professionalized in almost all settings, with independent directors of companies exercising much more authority than in previous years. Systematic attention needs to be given to the mix of qualities needed on boards, and achieving and maintaining diversity continue to be important in both sectors. In addition, the independence of board members is a more serious issue today than it was earlier—key questions include how to define independence and how to achieve it in fact and not just in appearance. I argue that independence should not be defined in too formulaic a way. In electing board members, it is also important to think through the proper role that shareholders and other constituents should play (the so-called majority-vote issue in corporate America).

Chapter 7 focuses on board “machinery,” including committee structures, the frequency of board meetings, board dynamics (how to encourage open discussion of the most important questions), and the proper use of executive sessions. I address the management of conflicts of interest (which it is naïve and even unwise to think can be eliminated altogether), the contentious issue of what to do about board leaks, and the relatively infrequent but gripping issue of when directors/trustees should choose to resign. I also consider how boards can “prune their trees,” removing directors or trustees who either are unwanted (for justifiable reasons) or simply have served long enough, whether boards should consider greater use of term limits to ensure freshness, and how mandatory retirement should be viewed. Finally, I suggest how boards can do a better job of evaluating their own performance than many do at present.

Chapter 8 is titled simply “Themes.” In it, I return first to the critical importance of the partnership between the chief executive officer and the board, and especially the CEO’s relationship with the board chair. Another recurring theme is the absolute necessity of having board members who possess courage and the will to act—at the same time that they recognize that board decision making is a collective responsibility and a “team sport.” I next reiterate the desirability of investing significant time and energy in governance questions up front, before a crisis is at hand. I also discuss the convergence of governance patterns in the nonprofit and for-profit sectors, and the important question of the desirable degree of convergence. Finally, I end the book by speaking briefly about the rewards—especially the intangible rewards—of board service.

Acknowledgments

I could never have written this book had it not been for colleagues and friends who, over many years, gave me the opportunity to work with them on boards of directors and trustees. These experiences have taught me so much, and I cannot overstate my debt to those who never hesitated to welcome my participation both in discussions of issues of every kind and then in taking actions. The actual writing of this book has been a lesson in collaboration, par excellence, and I want to reiterate my thanks to the legion of thoughtful and dedicated commentators who have done so much to improve the argument of the book. These cheerful critics have sharpened my thinking, often by challenging propositions that deserved a more careful weighing of pros and cons than I had initially understood. I have already listed these commentators, with identifications, earlier in the preface, and it seems invidious to single out individuals.

I cannot fail, however, to say a special word of thanks to those who provided not only substantive comments but also much encouragement and advice all along the way: Kevin Guthrie and James Shulman (chief executives of nonprofit start-ups with which I am involved on a day-today basis); Stephen Norman and Kenneth Frazier (officers of the two companies, American Express and Merck, that have provided the richest opportunities for me to learn about how boards work in the for-profit sector); and Lewis Bernard, Nicholas Katzenbach, and Paul Volcker (old friends who are simply wise).

Susanne Pichler, the exceedingly able librarian at the Andrew W. Mellon Foundation, has been my collaborator throughout the process of writing this book. She has worked tirelessly to suggest new materials, to locate obscure references, and to clarify both the text and the notes in countless ways. Susanne has been helped, in turn, by Lisa Bonifacic and Ellen Nasto. Johanna Brownell, my assistant in the Foundation’s New York office, has been an active participant in improving the manuscript and, more generally, in simply moving the project along. Her support has been critically important. I am grateful to John Hull, chief investment officer and financial vice president of the Andrew W. Mellon Foundation, and James Bailey and his colleagues at Cambridge Associates, who assembled information about private-equity firms and their governance.

My wife, Mary Ellen, has, as always, provided the support and encouragement essential to staying the course.

Finally, I want to acknowledge the unusually helpful role played in this project since its earliest days by Drake McFeely, president of W. W. Norton & Company, and his chief assistant, Brendan Curry. These two outstanding publishers took a personal interest in the book, and that has made a real difference. They also identified a talented copy editor, Stephanie Hiebert, who caught more errors than I ever imagined I had committed.

All of this help notwithstanding, I end with the usual acceptance of full responsibility for whatever faults remain. Warts and all, I hope that this book contributes in at least a small way to the governance by boards of directors and trustees of some of our society's most important institutions.

William G. Bowen
July 2007

1

Roles of Boards—and the Constraints They Face

SOME YEARS AGO, a onetime student of mine who had gone on to accomplish a great deal came to tell me that he had been invited to join the boards of two public companies. This was a new kind of opportunity for him, and he asked what factors he should consider in deciding whether to accept either invitation. Our impromptu conversation helped me appreciate an obvious point: many things that some of us have been fortunate enough to learn through experience, and that are available to us as subconscious background, are not necessarily generally known. Recognizing that there might be others, like my friend, for whom an overview would be useful, I summarize in this framing chapter some very basic propositions about boards: how they function, how they have been affected by changes in the context within which they work, and how for-profit and nonprofit boards are subject to somewhat different sets of constraints.

Why Are Boards Needed?

It is helpful to ask, right at the start, “Why do we have boards of directors and boards of trustees at all?” Why has this particular oversight mechanism seemed preferable in so many instances to other modes of governance? The simple answer is that the corporate form of organization is highly advantageous, and it requires boards. Nonprofits as well as for-profits benefit from the legal protections of the corporate form, especially limited liability, that distinguish it from the partnership or the unincorporated enterprise. In addition, it is easiest for nonprofits to satisfy regulatory requirements by incorporating and operating with the usual kind of governing board.

There is also a deeper set of considerations. Both for-profit and nonprofit entities operate in inherently complex settings in which matters are rarely cut-and-dried. The exercise of collective responsibility through the mechanism of a board can slow down decision making, but it can also dampen the enthusiasm of the aspiring autocrat. A properly functioning board provides checks and balances by adding layers of judgment and protections against abuse of power, self-dealing, favoritism, and just plain foolishness. More positively, the existence of a board encourages the development of a shared sense of institutional purpose and an awareness of the broader social, economic, and political context within which decisions are made. Nonresident directors and trustees can approach issues from a broader and more disinterested vantage point than can those immersed in day-to-day responsibilities. They can bring fresh perspectives to bear on tough questions at the same time that they can testify to outside constituencies on behalf of a company or a college.[1] In both for-profit and nonprofit sectors, boards can serve as valuable connectors between the work of a specific company or social-service provider and the external world that conditions the success or failure of the organization in so many ways.

To be sure, boards are more useful in some settings than in others. Derek Bok, former president of Harvard and a longtime member of nonprofit boards of various kinds, has pointed out that boards can be most useful when the organization is small and lacks a depth of staff expertise. In addition, boards can be most effective when at least some of their members have enough knowledge of the genre in which the organization works to contribute substantive ideas or raise big warning flags. Finally, small organizations that are in start-up mode, in either the for-profit or the nonprofit sector, are especially likely to benefit from the ideas and intuitions of wise directors or trustees. Venture capital firms typically insist on one or more board seats to monitor their investments and provide strategic advice. There are direct analogues in the nonprofit sector. In my own experience, trustees of JSTOR, ARTstor, and Ithaka—all small, entrepreneurial start-ups—have been enormously helpful in discussing both strategic directions and ways of getting things done.

Granted these advantages, boards are far from perfect instruments. Still, for most complex entities I remain convinced that the idea of a board of directors or trustees, when translated into an effective decision-making mechanism and populated with well-chosen members, is preferable to any known alternative.

What Do Boards Do?

At the most general level, all boards can be said to share a single overarching responsibility: *to build an effective organization*. Everything else is derivative. The late Kenneth Dayton, a major figure in both the for-profit and nonprofit sectors in Minneapolis, insisted that "governance is governance." Yet another wise and experienced observer, Nicholas Katzenbach, former US attorney general and onetime general counsel at IBM, has argued that for-profit and nonprofit boards differ fundamentally in what they are and in what they do. This is not a debate that can be settled in the abstract. Both perspectives have value.

Essentially all boards serve eight principal functions, though some are more important in one setting or another:

1. Select, encourage, advise, evaluate, compensate, and, if need be, replace the CEO

Walter Bagehot, an early editor of the *Economist*, once described the constitutional authority of the monarch as "the right to be consulted, the right to encourage, the right to warn."[2] In this context, we add the right to elect, to set compensation, and to dismiss. Although electing, compensating, and dismissing are actions that need to be taken collectively, encouraging and warning are often done by individual board members, as well as by the board as a whole. I will have much more to say about the electing, compensating, and dismissing functions in Chapters 3, 4, and 5. There is no way to exaggerate the importance of active board involvement in making decisions about CEO leadership and tenure.

A sometimes underappreciated (and less understood) function of boards is to give informal advice to the CEO or president outside of board meetings. A number of commentators regard this as the most important function of directors and trustees. Anyone who has been responsible for leading an organization certainly recognizes the need for candid advice from truly knowledgeable and concerned people who are at least somewhat above the fray. Of course, CEOs must be receptive to advice if it is to have value, and often those who need advice the most are the most reluctant to accept it.

2. Discuss, review, and approve strategic directions

In both for-profit and nonprofit organizations, this central task involves a more or less constant questioning of basic assumptions and priorities. Boards have an obligation to take a long-term view and to resist any tendency to place excessive emphasis on short-term considerations, whether quarterly earnings or an unexpected shortfall in donations. Both sectors are putting more and more emphasis on the strategic-planning function of boards, and this is all to the good—as long as process is not elevated over substance. There is a risk, which seems especially pronounced in the nonprofit sector, that merely extrapolating trends and building spreadsheets can become a substitute for thinking about priorities, hard choices, and what actually drives behavior.

There is also a danger of confusing participation in the direction-setting process with actual policy making. Boards in both sectors almost never make policy in any thoroughgoing way. Rather, they raise questions, debate policy choices, and eventually adopt or reject recommendations brought to them by the president or CEO. As Katzenbach has observed, the very thought of a board actually making policy, from scratch, is frightening in the extreme. Chaos would surely result. Policies need to be formulated thoughtfully, over time, through the sustained attention of full-time officers and competent staff.

Boards can, however, participate effectively in the policy-making process: first, by asking the right questions, which are almost never purely financial in nature; second, by making sure that each realistic course of action has been identified and that a good-faith stab has been made at weighing the costs and benefits of the main options; and, third, by occasionally introducing new approaches. When a board is functioning well, this process is easy, interactive, and iterative. It involves discussions among board members, the CEO, and perhaps other senior officers, with exchanges of ideas frequently occurring outside meetings as well as in them. Often no one is sure, finally, who first introduced an idea. A seamless process is a compliment to all concerned.

3. Monitor performance

Once the right leadership is in place and strategic directions and priorities have been set, the board's responsibility is to review regularly the progress of management in achieving agreed-on goals. Almost all corporate boards understand this responsibility, and they are accustomed to reviewing ongoing results against plan on a regular basis. Indeed, the real danger in the for-profit sector is that too much time and attention may be given to reviewing and parsing out small variations in outcomes from quarter to quarter instead of focusing on broader trends and emerging challenges. In the nonprofit world, on the other hand, it is surprising how frequently no real planning occurs—and it is even more surprising how frequently plans that were adopted are not tracked in even the most rudimentary fashion. In several specific situations, it proved impossible for staff at the Mellon Foundation, when reviewing grant proposals, to determine whether previously established goals were ever achieved.

In these respects, many nonprofits have much to learn from their corporate cousins. Being explicit about objectives and time frames, and paying attention to even simple benchmarks, can reduce the risk of big surprises. It should be recognized, however, that the monitoring task in some parts of the nonprofit sector is complicated enormously by both conceptual issues (what are the most important outcomes to measure, and how can they be measured?) and special accounting conventions.[3]

4. Ensure that the organization operates responsibly as well as effectively

Goals must, of course, be achieved in the right ways. Thus, an important obligation of all boards is to encourage the establishment of the appropriate "tone at the top" and to ensure the adequacy of policies and procedures for compliance with legal and ethical standards. Proper discharge of this important responsibility includes protecting the organization against conflicts of interest and being sure that proper controls are in place to monitor the expenses and the exercise of perquisites by management.

5. Act on specific policy recommendations and mobilize support for decisions taken

Whatever role boards play in developing and monitoring strategic plans, they have a clear-cut responsibility to act on specific recommendations that are operational as well as strategic. In both for-profit and nonprofit contexts, votes by boards on major policy issues serve the function of legitimizing decisions—and giving them a degree of finality—so that the organization can get on with its business. Although boards also review and sometimes approve decisions that are more managerial (for example, appointments of officers or salary increases for an array of staff members), board actions on recommendations in the strategy and policy arenas are especially significant.

As a corollary to the need to act on recommendations, boards need to mobilize support for decisions made, especially controversial ones. In nonprofit organizations, this is an absolutely critical function. To cite an experience of mine in the university world, Princeton's trustees voted, in 1969, to adopt a recommendation that Princeton become coeducational—a decision that seems so obviously right in hindsight that it is hard to recall how controversial it was at the time. This action by the trustees, which followed a lengthy process of study and debate, imposed closure on an issue that had to be settled and allowed the university to move ahead in an orderly way.[4]

6. Provide a buffer for the president or CEO—in the vernacular, "take some of the heat"

In parts of the nonprofit world, in particular, boards need to protect a president or executive director from the temptation to indulge idiosyncratic demands and self-serving pressures, including actions that serve only to placate a noisy constituency. In some situations, presidents may need to promise individuals—doctors on a hospital staff, faculty members in a university, or prospective donors to museums—that a matter will be presented to the board for consideration, even if the president has quite a clear sense of the likely (negative) outcome. It should be acknowledged, however, that in some situations board members themselves are the sources of strong pressure exerted on behalf of special interests. In a college or university setting, athletics is the most obvious example. Several commentators have remarked that special pleading by trustees can be a particularly serious problem in the foundation world, especially if a kind of "senatorial courtesy" is allowed to prevail. One experienced trustee (John Whitehead) has referred, ruefully, to "pork barrel reciprocity."

7. Ensure that the necessary resources, both human and financial, will be available to pursue the organization’s strategies and achieve its objectives

All boards have a collective responsibility to act on the key staffing recommendations that are so important in shaping the human resources available to for-profits and nonprofits alike, and, as discussed at length in Chapter 5, to strengthen succession-planning processes. Board members can also assist the CEO in motivating and encouraging members of the management team by paying respectful attention in formal meetings when officers other than the CEO make presentations and by getting to know these other officers in informal settings. In addition, board members can provide valuable support simply by being visible at ceremonial events and large-scale, quasi-public, managerial meetings. Woody Allen is right: there is much to be said for “just showing up.”

Boards of nonprofits dependent on contributions must also devote a great deal of time and energy to raising money and mobilizing volunteers. Individual trustees need to be responsible advocates, to make meaningful personal financial commitments, and to accept fund-raising responsibility. But board members of nonprofits also need to have a clear sense of when they should turn down proposed gifts, especially gifts in kind, offered unexpectedly. There are obvious dangers in taking on new responsibilities without both a clear programmatic case for doing so and a reason to believe that the resources needed over the long term can be secured. Kevin Guthrie, one of my colleagues at JSTOR and now president of Ithaka, has suggested that in many cases the wise advice is “Don’t take the Jaguar.” His reference is to a game show situation in which a participant wins a Jaguar and may be tempted to take the “free” prize without thinking carefully about what it will cost to maintain the car and pay insurance—never mind the income tax payments to come.[5]

In addition to generating new support, boards of nonprofits with significant endowments or other monetary assets must oversee the investment of the funds entrusted to the institution. Typically, nonprofits with large endowments depend on trustee investment committees and recruit board members with investment expertise. These boards also depend on in-house staff either to oversee the selection of money managers or to manage some assets themselves.

8. Nominate suitable candidates for election to the board, and establish and carry out an effective system of governance at the board level

Increasingly, boards in both for-profit and nonprofit sectors are assuming direct responsibility for the composition of the board and for the way the board discharges its duties. A board committee on governance is often the vehicle used to carry out this important function, which includes making sure that the board contains individuals of talent and integrity who contribute a range of perspectives. A sometimes unpleasant but necessary duty is to orchestrate the removal from the board of a director or trustee who needs to be replaced.

Return on Mission

Broad similarities notwithstanding, there are also deep-seated differences between the characteristic concerns and mind-sets of boards in the for-profit and nonprofit sectors. Mission is a particularly strong driving force in the nonprofit sector. In brief,

> *For-profit boards concentrate on developing and carrying out broad strategies for enhancing shareholder values; nonprofit boards are much more committed to the particular "missions" of their organizations.*

For-profit boards have no obligation whatsoever to pursue any particular line of business, and they may consider openly a wide range of strategic alternatives. The objective of the enterprise is not to continue doing any particular thing indefinitely, but rather to find the best way of deploying the company's capital and other resources. Mergers, acquisitions, and divestments are natural activities. Indeed, a key responsibility of for-profit organizations is to identify businesses that should be sold off, as well as to probe the desirability of striking out in new directions. The name "General Electric" (GE) tells us very little about the wide range of business that GE conducts today. As one person put it, the idea of being faithful to any product line either on the basis of sunk costs or tradition is "to sow the seeds of decline."[6] Of course, many for-profits have an interest in maintaining historical ties to particular fields of activity—a world in which Ford does not make cars would seem strange to many—but there's no escaping the rude truth that in 2004, the fiftieth year of the Fortune 500, only 71 of the 1,877 companies ever to have appeared on the list had been there since the start.[7]

The directors of nonprofits, in contrast, have not only the same legal duties of care and loyalty as board members in both sectors, but also what Daniel Kurtz calls a duty of "obedience."[8] This additional obligation commits trustees and directors to "act with fidelity to the organization's stated mission, within the bounds of the law." If a nonprofit board wishes to alter the fundamental objectives of the organization, "the participation and assent of some representative of the general public—for example, a state attorney general—and the agreement of a court may be required."[9]

In the nonprofit world, "organization itself has to be an outgrowth of mission and purpose," as Hanna Gray, a distinguished former president of the University of Chicago, explains:[10]

> There are basic reasons why academic institutions are organized and governed as they are, in the service of education and research and of excellence in these pursuits. Faculty are not just "professionals" with a commitment to their professions outside the institution as well as to the institution,…or odd types who tend to want collegial and complex decision-making. They are individual talents and intellectual entrepreneurs, demanding developers of their disciplines…who have in fact certain constitutional rights in the process of governance and who hold the most important authority that exists in a university, that of making ultimate academic judgments. And boards exist in part to ensure this freedom and creativity and to protect the processes and the health of the environment that make them possible. In short, they exist for the sustenance of a mission, for the perpetuation of an institution in which it is embodied over time in such a way that the future is not mortgaged to the present and, by fiduciary obligation, for the direct care and preservation of corporate assets entrusted specifically for the pursuit of a particular mission and its related goals.

In short, the governance of an academic institution is derived directly from its mission and from the way in which that mission is carried out by faculty. Other charitable nonprofits would define themselves in entirely different ways. It is no more likely that a nonprofit dedicated to improving the neighborhood on the south side of Chicago would become a university than it is that the University of Chicago would forget why it was created. Nonprofits are such a variegated lot precisely because each can be expected to have a strong attachment to a particular mission—an attachment that often lasts for generations. Harvard University is the oldest "corporation" on the American continent and has been a leading institution of higher education for more than three centuries. The American Philosophical Society was founded in 1743, and the New York Historical Society celebrated its two hundredth birthday in 2004.

Nonprofits may, and often do, extend their reach—wisely or unwisely—for either programmatic or financial reasons. What is today the Foundation for Child Development has been in existence for over a hundred years and started out as the Association for the Aid of Crippled Children. Whereas for-profit corporations can return capital to their shareholders, the "nondistribution constraint" prohibits nonprofits from even considering the option of returning any excess funds to "owners"—and thus inclines them toward expansion.

John C. Whitehead, on the basis of extensive experience at Goldman Sachs in the for-profit sector and as a trustee of numerous nonprofit organizations, including the International Rescue Committee, has provided a succinct summary of the central point:

> A for-profit board has an obligation to get out of a bad business while a nonprofit board may have an obligation to stay in, if it is to be true to its mission.

Focusing on mission is not, however, a simple matter; and nonprofits often face the difficult task of choosing among a variety of worthwhile activities within their area of emphasis. Then, in choosing among a multiple set of options, they need to seek what Kevin Guthrie calls "maximum return on mission." In Guthrie's words,

> Lots of people like to talk about how nonprofits must pursue a double

> bottom line. And how that is more complex. This doesn’t get totally at the issue. It is also a question of primacy. The nonprofit must use financial resources to serve its mission. It deploys financial assets, strategy, etc. to deliver a social benefit. A for-profit organization also pursues non-quantifiable objectives, but at the end of the day its objective is to maximize shareholder return.
>
> It follows that a nonprofit must come up with ways to measure not its financial return on invested capital, but its return on mission. This is really hard. How does it know it is having an impact? How does it measure its progress? Assessments of impact must be expressed not only in terms of the achievement of goals, but in terms of how leaders are measured. Successful nonprofits can lose sight of this and begin to evaluate themselves solely on the basis of financial results.

At the end of the chapter I will return to this key distinction in discussing the ways in which constraints on nonprofits differ fundamentally from those that operate in the corporate world. First, however, I want to discuss changes over the last several decades in the contexts and constraints that have affected the for-profit sector generally, and, by extension, the nonprofit sector too.

Changing Contexts and Constraints

Boards in both sectors operate within the settings that the world gives them at any point in time. There is simply no denying that the scandals of the last half dozen years, the attendant media attention, and the regulatory consequences have changed the assumptions and presuppositions that affect board behavior.

Scandals and Their Consequences

The Enron and WorldCom debacles are widely seen as markers of an era characterized by arrogance, greed, and outrageous corporate behavior. The collapse of Enron in late 2001 and the subsequent WorldCom bankruptcy had devastating effects on shareholders, employees, vendors, and whole communities. The dramatic failures of these two companies attracted an unprecedented amount of attention that led to the publication of books and reports, the making of movies, and criminal charges for some corporate officers.[11] Other widely publicized cases include Tyco, Fannie Mae, and the handling of Richard Grasso's exit package at the New York Stock Exchange.

There are lessons aplenty in both the unraveling of once proud corporate giants and the travails of some nonprofits—lessons that speak directly to core questions of board governance to which we will return throughout this book. In noting these cases, I do not mean to suggest that bad behavior is anything like the norm in either sector; on the contrary, I agree with those who have found much to praise.[12] Bad behavior is truly exceptional. Still, there is no denying that abuses and outright criminality have had major effects on the regulatory climate and on how the public at large views the work of boards. These developments have also contributed to a genuine shift in the balance of power within many large corporations.

By far the most consequential regulatory response was the near unanimous passage of the Sarbanes-Oxley Act (SOX) on July 30, 2002, in the immediate aftermath of the Enron bankruptcy and right at the time that the full extent of the WorldCom collapse was being reported. SOX requires public companies that are regulated by the Securities and Exchange Commission (SEC) to meet new standards. It calls for full disclosure of financial reports, including off-balance-sheet transactions; requires that these reports be certified by the CEO and the CFO; insists that management establish and maintain an effective system of internal controls; requires companies to tell the SEC what happened when a director resigns; and stipulates that there must be a truly independent, financially literate audit committee. This committee must include at least one "financial expert" among its members. It is responsible for engaging an outside audit firm that, with the committee, will assess the effectiveness of internal controls and ensure that any "material weaknesses" in those controls are made public.[13]

Any piece of legislation this far-reaching is bound to generate debates over whether its requirements go too far or whether the benefits of the legislation outweigh the costs of compliance. It is well beyond the scope of this study to assess the validity of these criticisms. From my own experience as a (long-suffering) member of the audit committee of American Express both before and after SOX, I can attest to the dramatic increase in workload that accompanied the new legislation. In keeping with others, I, too, wonder if there are not ways in which the objectives of the act can be achieved without so many bells and whistles. In any case, SOX is now, for better or worse, a major regulatory constraint on how companies regulated by the SEC must operate.[14] As Ezra Zilkha (a wise man and an astute investor who has served on many boards) observed, “Sarbanes-Oxley would not have been needed if everyone had remembered what they were taught as children: ‘Don’t lie, don’t cheat, don’t steal.’” But he then added, “Nonetheless, Sarbanes-Oxley was needed because people are who they are.”

One effect of SOX has been to make managers and owners of publicly traded companies more amenable to offers by private-equity investors to take over their firms. Even though this is not the primary reason for the explosive growth of the private-equity movement, which has been driven principally by the ready availability of cheap debt and the buoyancy of equity markets, it is easy to see why managers and directors alike might prefer to be freed from both the costs and the bother of what they may see as the excessive regulation that results from being a publicly traded company.[15] At the same time, as several commentators with experience running private-equity funds have emphasized, freedom from SOX cannot be a license to ignore financial controls. Independent directors, chosen by the private-equity firms, are often relied on to be sure that proper controls are in place.

An even more ominous deterrent to bad behavior than SOX may be the threat of criminal prosecutions. In an editorial that appeared the day after the Enron verdicts, the *Wall Street Journal* opined, “If anyone still thinks corporate chieftains are above the law, yesterday’s 29 guilty verdicts against former Enron CEOs Jeffrey Skilling and Kenneth Lay should put that myth to rest.” The editorial continues, “WorldCom CEO Bernie Ebbers is now facing 25 years…We think these convictions of individuals—some 30 in the Enron case alone—will do more to deter future corporate crime than anything in Sarbanes-Oxley.”[16]

One presumably unintended consequence of the combination of SOX, criminal prosecutions, and the demise of Enron’s accounting firm, Arthur Andersen, is that the accounting industry is widely perceived as having become much more conservative—too conservative in the minds of some. In the words of one commentator, “I think accounting firms, now fewer in number with more power than ever, are running scared in a way that is not productive.” It has been alleged that accounting firms sometimes put their own interests ahead of the interests of their clients, though this is of course hard to judge. Indeed, one problem is that the power of accounting firms is insidious, in large part because tenets are not always clearly stated and may not be subject to open debate.

Several other commentators, including Herbert “Pug” Winokur, who served on the board of Enron, have said that this entire set of experiences has led directors to ask a troubling question: how is a director to know when he or she is being lied to—either by management or by accountants and lawyers retained by the firm? This basic question of integrity, and how it can be assessed, is one that we will return to in Chapter 5. Let me anticipate that discussion by noting Winokur's conclusion: like it or not, directors simply have to be more proactive in probing the bona fides of all those on whom they rely for information.

Beyond Sarbanes-Oxley, there are other important changes in the context within which for-profit boards operate. First, there has been an unmistakable increase in scrutiny of the behavior of publicly traded companies—and of the effectiveness with which boards monitor this behavior. Investors, especially institutional investors, have become more aggressive in challenging the managements and boards of for-profit companies, and there are increasing references to "shareholder activism" and its effects. In a recent article, Institutional Shareholder Services (ISS) reported that thirty-one of fifty-one proxy fights that they studied ended in settlements, not votes, with concessions usually involving the award of one or more board seats to the challengers. Activists are not reluctant to launch fights, and they intend to keep the pressure on.[17]

One longtime observer of the corporate scene, Stephen Norman, secretary of American Express, notes that the average tenure of CEOs is shortening (see Chapter 5). Norman suspects that growing activism among shareholders has a great deal to do with this trend. Shareholders—and boards—simply will not put up with disappointing performance or evidence of a serious lack of judgment. The departures of Phillip Purcell at Morgan Stanley, Henry McKinnell at Pfizer, Robert Nardelli at Home Depot, and Richard Grasso at the New York Stock Exchange are frequently cited as cases in point.

Intensive scrutiny, especially by the media, has clearly become a more important constraint—and one more and more relevant to changes in corporate leadership. No one likes to be ridiculed or embarrassed, and many of us also prefer not to be challenged too aggressively by the media. This is certainly true of the members of governing boards. In recent years, the media have been much more active in tracking down questionable behavior and then sustaining a drumbeat of criticism. Stories in the *Wall Street Journal* and *Fortune* kept the pressure on executives at Enron, and apparently it was the press coverage more than the underlying business problems that bothered

Ken Lay. The head of PR at Enron was quoted as saying, “I’m working for a delusional chairman who thinks all the company has is a PR problem that can be solved with a press release.”[18]

Highly publicized debates over the leadership at Morgan Stanley, Pfizer, and Home Depot were certainly fueled by extensive press coverage. But perhaps the most striking example of the power of the media to affect the fate of a sitting CEO is the demise of Richard Grasso as the head of the New York Stock Exchange. As Professor Luigi Zingales at the University of Chicago Graduate School of Business observed, “In the case of Grasso and the NYSE, the SEC began to ask the NYSE board about its compensation practices after news of Grasso’s compensation was published in the *Wall Street Journal*. The publication of that news and ensuing public outcry forced the same directors who voted for his compensation package to fire him… Although all directors of the NYSE had voted in favor of his compensation, once the information became public—and even the most pro-business newspapers characterized Grasso’s compensation in a very negative light—many directors changed their position.”[19]

Freedom from intense, day-to-day public scrutiny is another appeal of going private. The purchase of Chrysler by the private-equity firm Cerberus will provide a good test of whether the world of private investment will in fact allow management to “focus with greater intensity on the day-to-day business of producing better cars.”[20] A real advantage of private-equity ownership is that management and directors are able to spend more time on key business issues (rather than on process questions) and do not have to worry about how analysts and investors will react to small blips in quarterly earnings—which are, after all, not reported. The focus is value creation. This emphasis on business performance presumes that at least some of the individuals named to the boards of private companies have real operating skill and knowledge of the industry. As several knowledgeable people noted, there is a danger that investors who are “financial engineers” will dominate these boards and be more concerned about capital structures and quick returns than about building economic value.

Several other broad changes in context have occurred. One has to do with what it means to be a shareholder. Increasingly, economic interests are being separated from formal ownership interests by the use of derivatives. In addition, the growth of index funds, which involve indirect ownership of a great many companies, complicates enormously the exercise of ownership responsibilities. Should index funds give back to owners the right to vote, as brokers do in the case of stock held in street names? These are not new issues, though they may well be more complex now than in earlier days. There is even speculation about the possibility of selling the vote, since mutual funds, for example, are generally not interested in voting their shares, whereas hedge funds might well be willing to pay something to control more votes.

The ironies of deciding who really represents ownership interests were brought home to me some years ago by Charles Exley's experiences at the time of the AT&T takeover of NCR. Although Exley himself had tens of millions of dollars of his own at risk, he nonetheless found himself challenged by representatives of institutional shareholders who had, as he put it, "not a nickel of their own money at stake." Even more interesting is the conundrum presented by index funds at that time—before they were as important as they are now. How were funds that held large amounts of both AT&T and NCR stock, and thus faced real conflict issues, to vote?[21] These were major complications that the NCR board, working with Exley, had to consider in deciding how to respond to the overtures from AT&T.

The rapid growth of pools of private equity and the increasing number of firms that are privately held illustrate one response to such issues.[22] Ownership interests are clearly represented in the case of privately held companies, including start-ups financed by venture capitalists and other firms taken private or kept private. In these situations, the interests of the real owners and the managers are closely aligned—much more closely than one finds in the publicly traded part of the for-profit sector. Both board members and managers have real "skin in the game." The opportunities for skilled executives to make large amounts of money leading privately held firms (assuming they are successful!) has had another effect on publicly traded companies: it has increased the competition for talent.

The growing use of governance rankings and governance quotients issued by Institutional Shareholder Services and other monitors of board performance presents yet another issue for board members. The way these organizations weight the various parameters included in their measures is often obscure. What is a director to think if his company's governance index is 39 and his competitor's is 93? As one commentator asked, "Should he execute his governance committee?" My own view is that boards should take seriously such rankings, but at the same time the board should not be the prisoner of an outsider's view of what constitutes good governance. There is nothing wrong with standing one's ground in the face of adverse rankings if, after careful consideration, that seems the right thing to do.[23]

Next I want to examine the spillover effects of these shifts in context and constraints on the nonprofit sector. This discussion will lead into an examination of the differences between the sectors in the kinds of external constraints that limit board options.

Regulatory and Media Constraints

In the world of the charitable nonprofits, there is no real counterpart to the scandals that have beset companies such as Enron and WorldCom. I cannot think of a case in which a major university, museum, or nonprofit service provider has been forced into the equivalent of bankruptcy. Of course, there have been controversies and instances of questionable behavior among nonprofits, but their effects have been less consequential.

Most commonly, issues in the nonprofit world have centered on the compensation, expenses, and perks of presidents and executive directors.[24] There was, for example, the spending scandal at American University in 2005, where lavish spending by former president Benjamin Ladner provoked an investigation by the Senate Finance Committee and led subsequently to major changes in governance. The Getty Trust in California found itself enmeshed in a number of highly publicized disputes, which ended in 2006 with the departure of CEO Barry Munitz, after numerous press accounts of questionable expenses and lack of adequate board oversight. The secretary of the Smithsonian, Larry Small, resigned in 2007 after an internal audit and congressional committees raised questions about expenses that he had charged to the Smithsonian.

Heightened scrutiny of compensation practices and perks has led trustees of nonprofits to reexamine both their policies and their oversight mechanisms. Many in the field have discussed whether to adopt SOX requirements voluntarily, since SOX applies only to for-profit companies that register securities with the SEC. A number of nonprofits have established separate audit committees and formalized processes for reviewing the compensation and expenses of presidents/CEOs, although few non-profit boards have adopted SOX fully.[25] Many nonprofits depend on fund-raising mechanisms that raise questions about independence and conflicts that, although important, differ in major respects from the corresponding questions in the for-profit sector. Furthermore, nonprofits may be reluctant to divert scarce resources to pay for the elaborate monitoring of functions, as well as the complex reporting, required of for-profit companies.[26] For these and other reasons, I agree with those who oppose a mechanical application of SOX to nonprofits.

My own view is that lawmakers should resist the temptation to respond to every instance of perceived bad behavior by passing a new statute. Jon Small, a former lawyer at Debevoise & Plimpton, and more recently the chairman of the Nonprofit Coordinating Committee of New York, noted that ninety-two of ninety-four abuses mentioned in a recent Senate study were already illegal! It is ironic that much of the pressure for more detailed regulations stems from the Internal Revenue Service's failure to invest enough resources to make sure that existing standards of right behavior are enforced.[27] Regulatory structures are, and should remain, the primary constraints on behavior in the nonprofit sector, but we should not have to rely more heavily on them than we do now.

A second set of constraints in the nonprofit world consists of those captured by phrases such as "media scrutiny" and "bad publicity." Like for-profit board members, trustees of nonprofits care deeply about both their own reputations and how the organizations with which they are associated are perceived. The changes in leadership, and in board governance, that occurred at the Getty Trust were, without question, provoked by the unrelenting media coverage of management practices, by the *Los Angeles Times* in particular. In the world of major museums, the Museum of Modern Art (MoMA) in New York City has surely suffered from the unfavorable publicity associated with the revelation of a largely secret fund used to supplement the salary of its director, Glenn D. Lowry.[28]

This "glass bowl" character of governance in many nonprofit settings, especially in higher education and the health care field, assures one kind of accountability that, if acted on in time, can be a protection against serious blunders. Or, if it comes after the fact, it can inform the need for changes in both staffing and governance. To be sure, intense media coverage can focus attention on the wrong issues and divert energy from questions that are more fundamental, but in general I am persuaded that the relatively high degree of scrutiny characteristic of colleges and universities is beneficial.

Both nonprofits and for-profits are also subject to internally constructed process constraints. Such constraints are especially important in colleges and universities. Long-established internal decision-making processes, including delegation to faculty of the responsibility for many curricular matters, as well as for academic requirements and academic appointments, constrain what trustees can and should do. By-laws and articles of incorporation serve similar purposes elsewhere in the nonprofit world and among for-profits.[29]

Regulation, media scrutiny, and internal process requirements are not, however, the most significant constraints on either nonprofit organizations or for-profit companies. Markets and quasi markets are almost always more powerful constraining mechanisms (except in the case of grant-making foundations, which I discuss at the end of the chapter), although they operate quite differently in the two sectors.

MARKET CONSTRAINTS AND “OWNERS”

The best-known companies operate in public markets, and dissatisfied shareholders can register displeasure simply by disposing of their stock (the “Wall Street Rule”). Share prices are quoted constantly, and rapid adjustments in prices and valuations tell their own stories—which of course financial analysts and media spin in one way or another. Shifts in market valuations represent more or less instantaneous votes of confidence (or no confidence) in corporate action or inaction. It was the marketplace that eventually shut off commercial paper financing for Enron, and short sellers played a major role in putting pressure on Enron’s stock price and thus on the company itself.[30]

For-profit organizations may have their futures altered dramatically by external buyers or sellers, as anyone who has participated in a corporate merger or takeover will attest. In such situations, the ultimate sanction is a proxy vote by shareholders to unseat recalcitrant directors. Having been unseated myself (along with the other members of my “class” of directors, in the final stages of the AT&T takeover of NCR), I can attest to the reality of this ultimate source of shareholder power. Large institutional investors are hardly bashful in letting companies know what they think about potential takeovers.

This story illustrates an important point: we should not glorify mergers or assume that the market always knows best. For reasons that were never clear, AT&T decided that moving actively into the computer field by acquiring NCR was “a strategic imperative” (in the words of Robert Allen, the CEO and chairman of AT&T at the time). After a hard-fought proxy battle, AT&T

was able to use its financial muscle to gain control of NCR—a takeover that ended up costing AT&T and its shareholders billions of dollars. The NCR of that time was essentially destroyed, although it has since been born again after having been spun off by AT&T. As Exley put it, one lesson of this sad experience is that "a sick elephant can kill a healthy dog by just falling on it" (a phrase he attributes to the legendary head of the Burroughs Corporation, Ray W. MacDonald).

Technological changes can also compel boards of for-profits to shift directions. In the 1970s and 1980s, IBM was forced to shift from heavy reliance on mainframes to distributed processing. As Charles Exley, then CEO and chairman of NCR, explains what happened,

> IBM…was the victim of a technology revolution which spelled big trouble for the company no matter what they did. When you make the best milk bottle in town [mainframe computers] and someone discovers milk cartons [distributed processing], you confront one huge problem to which there are no easy solutions.

More generally and less dramatically, capital markets are constantly regulating the behavior of for-profit companies—especially those that cannot rely solely on retained earnings to finance themselves. In many situations, corporate strategies and their implementation are applauded or dismissed via third-party decisions to provide or withhold capital. Specialists in industrial organization and corporate finance will continue to debate just how efficient capital markets really are, whether "short-termism" is a serious malady in America today, and if complaints of underinvestment in certain fields are justified.[31] No one doubts, however, that markets in general influence and ultimately constrain board decisions.

This is hardly to say that we are living in an "Adam Smith age" in which atomistic units respond automatically to the signals provided by impersonal, unseen market forces. There are plenty of opportunities for boards to make big mistakes, just as there are opportunities to find the right new direction before others do.

In the nonprofit world, certain constraints also mimic market forces and resemble those present in the for-profit sector. For example, the leaders of performing-arts organizations remind us regularly that market demand matters greatly to the health of their organizations, as it does to museums and many historical societies that rely on paying visitors for revenues. Such entities and many other nonprofits that provide services also have to pass what are, in effect, market tests of another kind when they recruit volunteers and appeal to donors to raise funds. We are reminded every day that educational institutions compete vigorously with each other for students and faculty, as well as for charitable contributions and government funding. As their stepped-up advertising attests, nonprofit hospitals and health care providers compete for patients as well as for private and public funding.

Important as they are, the market and pseudomarket constraints faced by nonprofits tend to be less circumscribing than those encountered by directors of for-profit entities. Nonprofits can choose among a wider variety of objectives, and they can assign a wider variety of weights to different objectives, than can for-profit entities, which are presumed by their shareholders and others to have earnings and profits always in mind. In the nonprofit world, outputs and outcomes are harder to measure, and constituencies harder to define. Normally, no single measure of success is analogous to the proverbial bottom line for a business.

One of our commentators with experience on both nonprofit and for-profit boards (Nicholas Donatiello) argues that "owners" provide clear guideposts in the for-profit sector that are just not available to nonprofit boards. In his words,

> Directors of for-profit companies have an absolute obligation to act in the best interest of shareholders. While there is much judgment involved, including choosing the right [time] horizon and respecting employees and customers who are critical to the long-term success of the enterprise, there is no uncertainty about the objective. In nonprofits, determining what should guide decisions is a more complex calculus. The mission of the organization is seldom a sufficient navigational beacon. Often the interests of the constituencies being served must be balanced against those of donors, members, and volunteers.[32]

Nonprofit boards enjoy more freedom from market constraints than do their for-profit cousins for another reason. As a general rule, fundamental choices can be made by nonprofit institutions without the worry that these decisions may be subject to abrupt reversal by market forces. After all, nonprofit entities are not routinely for sale, and mergers and closings in this sector tend to occur only rarely, when nonprofit institutions are in deep trouble. One would not find an NCR–AT&T takeover example in this sector. The lack of regular buy-and-sell markets for nonprofit organizations, and the almost complete absence of takeovers, is a major difference between the two sectors. It helps explain why, as we noted earlier, companies are much less likely to have long lives than, say, any of the numerous colleges and other nonprofit organizations that have been in existence since the eighteenth century.

I think it is fair to say that, overall, nonprofits as a group are far less closely constrained by external forces than are for-profit organizations. The combination of global competition, daily market checks, aggressive institutional investors ("owners"), and highly engaged business media is powerful. Nonprofits, in sharp contrast, have no well-defined owners or external overseers (apart from the board itself), and in fact, only rather poor substitutes for them exist. In rare cases, the attorney general of the state in which the nonprofit entity operates (or is chartered), or the courts in that state, will become involved—but only in extreme circumstances.[33] These politically chosen representatives of the public interest are, ultimately, the nonprofit world's owners of the underlying assets, but they exercise far less oversight than do owners and their surrogates in the for-profit world.

There are, however, some quasi owners in the nonprofit sector who are likely to exert influence well before the attorney general or the courts are aware of a problem. In the case of membership organizations, the members themselves serve this function. Individual directors and trustees are a second broad class of potential watchdogs. Although the law is not as clear as it might be concerning "standing" in the nonprofit sector, both members and directors plainly have the right to bring suits in court. Beyond these groups, however, accountability is hard to pinpoint. In the usual case, no constituency has legal power to elect trustees or directors; most nonprofit boards are self-perpetuating.

Large donors may be thought to constitute another set of quasi owners, since their largesse is critical to the long-term well-being of many organizations. Understandably, nonprofits are reluctant to offend generous patrons. This is partly a matter of feelings of obligation and of good faith—

respecting wishes and intentions. Trustees of foundations may well hark back to the interests of a principal donor when considering directions and priorities, but this is generally more a matter of respect than of obligation. In other contexts, concern for the views of donors can be a matter of prudence—especially if the donors are still alive and might make additional gifts! Boards of colleges and universities are often sensitive to the likely response of alumni to decisions they might make, as are boards of organizations of all kinds that have established donor bases. Public universities must be alert to the views of key legislators. The Smithsonian, a unique institution that nonetheless is in some ways similar to large public universities, is subject to scrutiny by Congress, which has demonstrated that it can exert influence by refusing to approve appropriations or by simply embarrassing those charged with the governance of the institution.[34]

More generally, accountability is usually related to dependence, and any nonprofit that is dependent on a particular individual, corporation, government funder, or constituency will pay more than passing attention to the views of the individual, entity, or group in question. This is a major reason why the boards of nonprofits that value their independence attach such importance to achieving a diversity of funding sources. Of course, most nonprofits are dependent on far more than donors, and the same principles apply to audiences, clients, and other potential purchasers of services. Nonprofits that lack a well-established base of donors or that must rely on their ability to attract substantial earned income can be nearly as likely to go out of business as a family restaurant or small shop, though exits are heavily concentrated among new, and small, entities.

The wide range of circumstances notwithstanding, the fact remains that significant numbers of nonprofits function for years, sometimes struggling along, without attracting the attention of powerful outsiders. Because of the lack of access to most of the mechanisms for radical transformation that markets represent, some nonprofits may survive too long. The questions of when and how to transform, or even to dissolve, a nonprofit entity are both major challenges to boards and of great significance as issues of public policy. But they attract attention only when a combination of the press and political interests alerts the general public to the travails of a venerable organization such as the New-York Historical Society (which, in the late 1980s and early 1990s, was in danger of being unable to continue to support its outstanding library).[35] Generally speaking, by the time an alert of this kind has been sounded, a number of perhaps promising options will have been closed off altogether or made much more expensive.

Finally, a special note is in order about constraints, “ownership,” and accountability in the sector in which I worked for eighteen years: the world of the large grant-making foundation. This subsector is more insulated from external constraints than are either for-profits or other nonprofits. Few constituencies can be relied on to challenge the leadership of a foundation or the directions it is taking. In contrast to the university world, there are no faculty members, students, parents, or alumni to function as counterweights —and no student newspapers! In addition, grantees are usually reluctant to criticize or complain. A leader of one foundation is reputed to have said to someone who was about to assume a similar role, “You will never again have a bad lunch—or hear the truth!”

As noted earlier, foundations are, of course, subject to the terms of deeds of gifts and the charters that established them, and they are likely to feel an obligation to respect the wishes of their donors. Foundations are subject to some degree of public scrutiny, as well as to myriad government regulations, and, on occasion, to review, if not discipline, by membership organizations such as the Council on Foundations. Nonetheless, trustees retain a great deal of leeway within which to set directions and make choices. *In my view, the trustees of foundations have more opportunity to affect institutional performance than do the directors of any other set of entities in either the for-profit or nonprofit sector.*

This is not at all a bad thing, assuming that proper oversight is provided by responsible boards of trustees. Considerable freedom of action is one of the great strengths of independent foundations, and a major justification for the tax privileges that they enjoy. Such freedom is especially important in a society in which it is often hard to generate support for programs that serve broad public purposes. In my view, our society needs private initiatives able to overcome bureaucratic impediments to change, as well as other forces of inertia, and to test out ideas. I would much prefer to live in a world in which freedom of action leads to some poor decisions (as will inevitably be the case) than in a world in which foundations are fearful to strike out in new directions or to support unpopular causes. The challenge is to find ways of preserving freedom of action while simultaneously meeting proper standards of accountability. It is in reconciling these objectives that trustees of foundations have a decisive role to play.

IN THIS CHAPTER I have outlined the roles and responsibilities of boards in both the for-profit and the nonprofit sectors, as well as described the contexts and constraints that inescapably influence the decisions made by directors and trustees. Board members in both sectors have the obligation to steer their organizations as best they can, given the choices that their settings present to them. It is not, however, for boards alone to define strategies, never mind execute on them. Boards can be effective only if they develop a strong partnership with the day-to-day leadership of the organizations for which they are responsible. In the next chapter I will discuss the evolving relationship between boards and their CEOs/presidents. Getting this key relationship right is arguably the most important challenge faced by boards of directors and trustees.

2

Board Leadership

ONE OF THE MOST hotly debated issues in corporate governance is how best to define the relationship between the board and the CEO. Commentator after commentator told me that this is *the* key question. Some argue passionately for separating the roles of chairman and CEO, which has long been the practice in the nonprofit sector and is the norm today in the United Kingdom and in Canada. Others believe that giving one person both roles is the most effective way to provide leadership for the company and the board. Still others believe that the right answer to this question, as to most interesting questions, is, “It all depends.”

I am convinced that there is much to be said for taking a practical, “situational” perspective. But that does not mean that we should be agnostic about what arrangement would be best in a perfect world, and I begin the chapter by assessing the conceptual arguments in favor of both separating and combining the roles. My conclusion, let me say up front, is that the arguments in favor of the separate chairman model are persuasive at the level of first principles. Certain practical considerations, however, argue in favor of the single CEO-chairman model in particular situations. Taking into account these situational considerations leads to an examination of the increasingly popular lead director model, whether seen as a long-term organizational solution or as a transitional stage in the evolution of the relationship between boards and their CEOs.

My own intuition is that the lead director model may indeed prove to be transitional and that we will see a slow-paced movement toward a separation of the roles of chief executive officer and chairman. The chapter concludes with a postscript in which I discuss the reasons for the persistent differences that we observe in the typical board–CEO relationship when we compare the for-profit and nonprofit sectors.

A Separate Chairman? The Conceptual Arguments for and against Splitting the Roles

Splitting the roles of chairman and CEO in the for-profit sector has two major advantages. A separate chairman

(1) Positions the board to exercise properly its key oversight responsibility vis-à-vis the CEO, reduces the risk of autocratic rule by creating a regime of checks and balances, and promotes a healthy dynamic in board deliberations
(2) Divides a heavy workload by allowing the CEO to concentrate on managing the business while the chairman concentrates on managing board affairs

The fact that the CEO works for the board, which represents the shareholders, is a prima facie case for separating the board's oversight function and the CEO's management function. As a writer for the *Financial Times* argues, "There is a clear conflict of interest between leading a board that oversees a company's management and being the senior manager."[1] Worries about excessive concentration of power in the hands of one person are widely shared. In the words of John Whitehead, "One man rule is a bad idea. A single CEO-chairman can do great damage before being reined in—often when it is too late, or almost too late." Separating the roles of chairman and CEO is the most obvious way of addressing this concern. Paul Volcker agrees. He writes, in his characteristically direct way, "The board's inescapable and prime responsibility is hiring and firing the CEO. The firing part is hard, often botched, and typically delayed. A chairman will have a greater sense of authority and responsibility in his own eyes, in the eyes of the board and the CEO."[2]

Following this checks-and-balances line of argument, some management specialists have claimed that "corporate disasters can be traced to concentrating power at the top."[3] Dick Debs, one of the "eight grumpy old men" who led the revolt at Morgan Stanley resulting in the ouster of Philip

Purcell as CEO and chairman, is quoted as concluding: “Our struggle showed the fault lines in the US system of corporate governance. Here we had one man who was the boss, the CEO and the chairman, who was able to stack his board with friends and allies, keeping them happy with rich compensation and extensive perks, isolated from the people who worked for the firm.”[4]

It is certainly true that decisions to split the chairman and CEO roles have often followed scandals or near-scandals. Conversations with a number of experienced directors have led me to the not surprising conclusion that board members who have been through an excruciating crisis involving the performance of a CEO are the most likely to be strong advocates of splitting the roles. Several people with whom I spoke emphasized that in earlier days they did not favor separating the roles, but they certainly do now—and at least one went on to describe his “conversion” in passionate language that had almost a theological tinge. Having “been there” obviously helps people see what can happen when power is concentrated in a single CEO-chairman.[5]

It is tempting to cite WorldCom and Enron as examples of disasters that occurred in spite of a separation of the roles of chairman and CEO, but in both cases the chairman was the former CEO and was deeply implicated in the problems that led to the collapse of the company. These cases hardly illustrate how a separate chairman can be an effective counter-weight to a wrong-headed CEO. In fact, I believe that having a former CEO serve as non-executive chairman can have a decidedly negative effect: such an arrangement can interfere with the often necessary task of reexamining directions taken in the past and reaiming the organization.

One telling piece of evidence in favor of separate roles comes from the insurance companies that must assess the risk they accept in writing policies covering directors’ and officers’ liability. Lou Ann Layton, managing director in charge of national directors’ and officers’ liability insurance at Marsh, has been quoted as saying, “We always ask, ‘Are you considering dividing the titles, and if not, why don’t you?’”[6] Peter Tulupman, a spokesman for AIG, has observed that companies that split the roles are starting to ask for discounts. The Council of Institutional Investors, whose members include most large pension funds, favors having independent directors as board chairs.

A related argument concerns the effect of splitting the roles on board dynamics. In explaining why he has come to believe so strongly in separating the positions of chairman and CEO, one highly experienced director said simply, “Having a separate non-executive chairman just changes the entire dynamic; it is a way to avoid cronyism, and it both encourages more open discussion among board members and allows management people below the CEO level to feel freer to talk with the chairman.” In explaining why he favors having a non-executive chairman, Ezra Zilkha stresses a related need: “for board members to have a legitimate place to go if they have concerns or questions.”

Nicholas Katzenbach, former attorney general and undersecretary of state, as well as a onetime general counsel at IBM and later chairman of the WorldCom board after it was reconstituted, also favors a separate non-executive chair. Katzenbach worked closely with Robert Kennedy, and he told me that Kennedy was very, very good at getting each participant in a discussion to say exactly what the participant believed. In the Cuban Missile Crisis, Katzenbach recalls that Bobby Kennedy did not want the president to be part of the discussions because he knew that the president’s presence would be intimidating and that the others would not speak up. Katzenbach’s analogy in the corporate context is that having the CEO chair board meetings can inhibit a candid exchange of views. The dynamics will be better with someone else presiding, Katzenbach opined, and this is also why executive sessions, without the CEO even in attendance, are so valuable.

The second main reason for splitting the roles of chairman and CEO emphasizes the need to achieve a sensible division of labor in the governance of large and complex organizations. As Larry Bossidy has observed, “The CEO job is much more challenging today. Worldwide competition is more intense; because of the Internet, required speed of response is much faster; constituents demand more attention, and more attention now. In short, the CEO needs more help.”

If the right people can be found for what should be two highly complementary roles, and *if* the right relationship can be established between them (and these are two big ifs), there is much to be said for dividing the work. The CEO’s focus should be on running the business, and it can be very helpful if the CEO has a competent colleague who can manage board matters. An effective non-executive chairman will facilitate constructive interactions within the board and between the board and management—without competing with the CEO or interfering in the management of the business itself. A non-executive chairman can also be a helpful point of contact with large institutional investors, giving them, as outsiders, a recognized place to go to raise questions and voice concerns. Increasingly, large institutional investors expect to have access to the board, as well as to the CEO, and it is in everyone's interest to have such interactions channeled appropriately.[7]

In certain contexts the presence of a non-executive chairman can also protect both the CEO and the board from what the late Alan Pifer, president of the Carnegie Corporation, referred to as "the occasional bully who can appear on any board." Controlling such behavior is necessary, if other board members and senior staff members are not to be intimidated. A separate chairman may be more effective than a CEO in curbing such tendencies and, if necessary, in seeking the resignation of the offender. The CEO, after all, works for the board—and, therefore, for any bullies who may be on it. The chief executive should not have to deal personally with the inappropriate behavior of cantankerous board members.

Furthermore, as Louise Parent, general counsel of American Express, has pointed out, the law and regulatory requirements make it clear that the CEO simply should not (and cannot) do certain things: lead the process of nominating and selecting new board members; evaluate the work of the board collectively, as well as the performance of individual directors; orchestrate the work of an independent audit committee; and organize a responsible process for evaluating the CEO and setting the CEO's own compensation. To be sure, these tasks can be handled collectively by independent directors through appropriate committee structures, but a non-executive chairman can ensure that they are carried out in an orderly, well-coordinated way.

It is instructive that Mark Hurd, CEO of Hewlett-Packard, when asked why he had not paid more attention to the board's investigation of board leaks, acknowledged that he was at two meetings where the investigation was discussed, but said that he did not pay attention because the investigation was not as high a priority as running the company. "I pick my spots where I dive for details," he is reported to have said.[8] Having been made CEO in the aftermath of the firing of Carly Fiorina and in the context of a heated debate over the direction of the company, it was entirely understandable—and sensible—for Hurd to want to focus on getting his hands around the core business/strategic/management issues at HP.

Unfortunately, however, the non-executive chairman, Patricia Dunn, did not handle the investigation of board leaks well. Because neither of the two big ifs was satisfied, this effort to take advantage of the principle of division of labor, as well as to provide proper oversight of a new CEO, failed. But the lesson here is not that splitting the roles is inadvisable; the CEO should not be expected to do everything, especially in early days at the helm of a ship that needs strong steering. Rather, the lesson is that it is critically important to have the right combination of highly competent players in place, and to have a board that functions well in general (is the opposite of dysfunctional, as various commentators have described the HP board). An even broader lesson of the bizarre HP experience is that a well-conceived formal leadership structure is, in and of itself, no guarantee of good governance.[9]

The Merck board's 2005 decision to elect an insider, Richard Clark, as CEO—but not to ask Clark to start out by serving as chairman too—has had a much happier history. Like Hurd, Clark needed to concentrate on core business issues. At the time, the entire pharmaceutical industry was being challenged, Merck was embroiled in the VIOXX litigation, and major organizational and strategic issues inside the company needed to be addressed. For reasons peculiar to the Merck situation, an unusual organizational structure was put in place for a limited time. A small executive committee was created, consisting of three independent directors: Larry Bossidy, former chairman and CEO of AlliedSignal, who chaired Merck's Compensation Committee; Samuel Thier, former head of the Institute of Medicine in Washington and most recently CEO of Partners HealthCare in Boston, who chaired the Public Policy Committee; and me, as the chairman of Merck's Governance Committee and the special committee investigating the development and marketing of VIOXX. This executive committee, chaired by Bossidy, was asked to discharge the chairman's role in a collaborative fashion, on the explicit understanding that this was to be a transitional arrangement.

Outside observers questioned whether this seemingly unwieldy beast could walk at all, never mind run. In fact, however, the arrangement worked well—in large part because the three of us had complementary skills, were comfortable working together, and had a high regard for Dick Clark, who performed superbly as CEO. The arrangement was helpful to Clark, he said, in part because he gained assistance, feedback, and support from three directors, each of whom had something to contribute in the areas that each of us knew best. Relatively minor aspects of this arrangement might have been improved upon, but overall, Clark and the Merck board judged the experiment a success.

In addressing the larger question of whether separation of the roles of chairman and CEO can serve corporate goals effectively in a large number of situations and over a considerable period of time, it is helpful to consider the extensive experience in the United Kingdom and Canada. Splitting the roles is the norm in these countries, and testimony from, among others, David Kimbell, co-leader of Spencer Stuart's board services in Europe and worldwide chairman of Spencer Stuart from 1987 to 1999, is instructive. Kimbell writes, "Most observers, as well as chairmen and CEOs themselves, would agree that separating the roles has been good for British business."[10]

A Booz Allen Hamilton study of CEO turnover and various succession models found that, in 2005, shareholder returns were higher in situations in which the CEO and chairman positions were separate and the chairman was not the previous CEO. These results held for both Europe and North America. A later Booz Allen Hamilton study found that "in 2006, *all* of the underperforming North American CEOs with long tenure had either held the additional title of company chairman or served under a chairman who was the former CEO."[11] In both 2006 and the nine-year period ending in 2006, the study found, investors earned appreciably lower returns if the CEO was also the chairman of the company or served under a chairman who used to be the CEO.[12]

The conceptual arguments for separating the roles of the chairman and CEO are powerful. What are the main offsetting arguments? As several commentators have noted, the strongest points in favor of combining the roles focus on practical reasons why a division of responsibilities either will have bad consequences or simply is not needed, and I examine these propositions in the next section. In addition, however, there is one conceptual argument in favor of having the same person serve as CEO and chairman that needs to be considered:

> *The one-person CEO-chairman model avoids the risk of confused signals, or disharmony, at the top of the organization.*

There is the risk of ending up with, in the words of one observer, "ambiguous leadership, split allegiances…, and an incoherent vision for the company's future."[13] Such an arrangement can create the potential for rivalry between the chairman and the CEO, leading to ineffectual compromise rather than crisp decisiveness. In short, it may be more efficient to have a single individual responsible for everything.

There are two rejoinders to this line of argument:

(1) Although it is certainly possible to have individuals in these positions who are so at odds that the company will be damaged by the latent if not actual conflict, there is absolutely no reason to create (or tolerate) such a situation. Great care must be taken to define the roles clearly and to be sure that the chairman will not undermine the CEO—who has to be, without question, the individual responsible for leading the company. The chairman, in turn, should be responsible for leading the board, but quietly and in ways that underscore the partnership between the chairman and the CEO. Except in unusual circumstances, there is no reason for the chairman to speak on behalf of the company to the press or to others outside the boardroom (meeting with large institutional shareholders at their request, and with the approval of the CEO, can be one such circumstance). The CEO should run the annual meetings and handle conference calls with analysts.

(2) Efficiency is not the objective; maximizing outcomes for shareholders is. Autocracies sometimes make for efficient governments—with "the trains running on time"—but they are not good models for providing responsible oversight, stimulating productive debate, or achieving complex objectives that often require balancing a number of competing interests.

I do not believe that the conceptual arguments for and against separating the roles of CEO and chairman are anything close to even. In my view, the conceptual case for separation is extremely powerful—close to compelling. Why, then, do so many American companies continue to combine the roles? The answer is that practical considerations can overwhelm conceptual arguments and rebut any general presumption in favor of having a separate chairman.

Practical Considerations: The Need to Take a Situational Perspective

In any given situation, directors may conclude that the CEO and chairman roles should be combined for three practical reasons:

(1) In corporate America today, most CEOs want both titles (for status and other reasons), and it can be dangerous to offend them. Insisting on separating the roles can also make it harder to recruit an outstanding CEO.

(2) The right candidate for chairman may not be available.

(3) Splitting the roles of chairman and CEO is an unnecessarily contentious way of meeting the need for checks and balances and achieving a good division of labor. Effective use of the lead director model is an attractive alternative that avoids, in particular, the status issue associated with depriving the CEO of the chairman title.

To begin with the status issue, it is widely understood that most CEOs want to be seen as fully in charge, and it continues to be true in the United States, though apparently not elsewhere, that CEOs who are *only* CEOs sometimes feel that they have been given half the job and are not trusted with full responsibility. A British commentator suggested that this is the "alpha male (or female)" syndrome at work and that "a combination of crowd psychology and vanity is probably to blame. No one wants to turn up at the golf club as a mere chief executive, no matter how well-rewarded his job and big his company, to be surrounded by two-title guys."[14]

This comment may overstate the status aspect of the question, but status does matter to people and separating the roles can raise questions concerning the authority of the CEO. At Merck, when Dick Clark was named CEO but not chairman, some questioned whether Clark was really in charge, and occasionally made snide comments such as "Dick Clark riding on training wheels." Fortunately, these questions were put to rest through a combination of effective leadership by Larry Bossidy (as chairman of the three-person executive committee), and the outstanding job that Clark did as a CEO who was clearly in charge.

In any event, the bald fact remains that most corporate CEOs in the

United States are opposed to having someone else serve as chairman. If a CEO-chairman is doing well, the board is highly unlikely to risk aggravating its key leader by even raising the question. If the board is seeking a new CEO from outside the company, separating the roles can make it harder to recruit an outstanding candidate, especially if the individual already has both titles in another company. Finally, if the two positions have been separated during a transition and the new CEO then performs exceptionally well, there can be a strong inclination to reward good leadership by giving the CEO the additional title of chairman.

Boards in the United States are thus forced to confront a rather deep-seated cultural issue when considering the separate chairman model, and the right decision at a particular moment in time may be to allow custom to prevail. In electing new CEOs, however, I believe that boards should be more aggressive than they have been in trying out the idea of a separate chairman. Some highly qualified individuals have been willing to accept CEO jobs without the chairman title. If the separate model has been established, boards should resist the temptation to use the chairman title as a reward for good performance—even as we recognize that, as a practical matter, recombining the roles is sometimes the right thing to do.

The second practical reason for concluding that the roles of CEO and chairman should be combined (or recombined) is far more important than many people suspect. I am referring to what I call the "availability problem": it may be anything but easy to find just the right person to serve as non-executive chairman at just the right time. It is tempting to assume that any prominent organization will have a ready claim on several worthy candidates, but my own experience and my reading of the experiences of other organizations, suggests that this is a wildly optimistic and even dangerous assumption.[15]

To appreciate the seriousness of this concern, it is helpful to ask what attributes make a person well qualified to serve as non-executive chairman. Here is a provisional list (in no particular order) that may be helpful in its own right and that may also underscore the difficulties involved in finding a good candidate to be non-executive chairman:

- Unquestioned integrity and high ethical standards
- Intelligence, a good listening capacity, an abundance of common sense, and an ability to build consensus

- A full quiver of interpersonal and communication skills
- A constrained ego, since, in the words of one commentator, “no egomaniac can energize colleagues”
- The promise of an excellent, mutually respectful relationship with the CEO
- Knowledge of the business in sufficient depth to understand well the key strategic issues, and a strong belief in the value of what the organization is doing
- Experience as a CEO of a reasonably complex organization that allows the prospective chairman to appreciate the tasks of the CEO and the pressures under which the CEO works
- Ideally, previous service on the board of the company in question, so that other board members are comfortable with the person in charge
- Willingness to commit the time necessary to stay in touch with “the campus” and to be available for regular consultations with (in particular) other board members and the CEO

It will almost always be difficult to find an individual with a large majority of these attributes, never mind all of them. In light of this daunting list, it is hardly surprising that even companies that have had good experiences with the separate chairman model may feel that they have to recombine the roles at some juncture. In the case of Merck, at the time of the search for a successor to Ray Gilmartin as CEO, the board looked energetically outside the company as well as inside it for someone who could serve as non-executive chairman, at least for a time. It turned out to be exceedingly difficult to identify promising candidates. One highly qualified member of the Merck board, Larry Bossidy, eventually agreed to share the role of chairman with two other board members, but Bossidy was adamant in declining to serve as chairman by himself.

The Hewlett-Packard case is also instructive. Some commentators were highly critical of the decision by the HP board to recombine the roles of CEO and chairman following the resignation of the chairwoman, Patricia Dunn, in the wake of the extraordinary controversy over board leaks and spying at HP. A British commentator, John Gapper, wrote that “the board of Hewlett-Packard has behaved pretty eccentrically of late, but its decision last week to make Mark Hurd chairman of the board of directors as well as chief executive takes the biscuit. Hello? If any company has proof that chairing a board is an important job in itself and not merely a nice additional title for a chief executive, it is HP."[16] I am in no position to evaluate the qualifications of other board members at HP to assume the chairmanship, but I would not be quick to assume that it would have been easy to identify someone able and willing to serve at such a highly contentious time. In addition, getting the board and the CEO back together, solidifying relationships, had to be a high priority. This could well be a prime example of an instance in which situational considerations dictated the decision to recombine the roles.

Focusing attention on the importance of pools of candidates able and willing to serve in these leadership roles also helps us understand why the British experience with separation of the CEO and chairman roles is so different from the American experience. Executives in the United Kingdom, where mandatory retirement at age sixty was only recently abolished, tend to retire earlier than they do in the United States. These retired CEOs form a sizable pool of strong candidates for the non-executive chairman positions that are common in Britain.[17]

The third and final argument for continuing to combine the roles of CEO and chairman is that the real benefits of separation can be achieved through other governance mechanisms—in particular by adoption of the lead director model. Much has changed in recent years, and there are undoubtedly more effective checks and balances in place now than there were even five years ago. Board members are in fact, as well as in appearance, more independent; board recruitment has become far more professionalized and less dependent on the CEO; executive sessions without the CEO are now the norm; and boards have demonstrated an increasing willingness to challenge and replace underperforming CEOs. Lead directors have become very important in achieving a better sharing of responsibilities between the CEO and the board. Indeed, the institutionalization of the role of lead director is the single most important governance reform of recent years in the for-profit sector. This organizational development is so important that it merits a section of its own, before I comment on how the different organizational models are likely to sort themselves out over time—and how I believe they should sort themselves out.

The Lead Director Model

This is one idea whose time certainly appears to have come. Spencer Stuart reports that as of mid-2006, 96 percent of all S&P 500 boards had designated a lead or presiding director, up from 36 percent in mid-2003 and an infinitesimal percentage a dozen years ago.[18] In some cases, no doubt, companies adopted this model simply because they knew that the New York Stock Exchange and rating agencies expected them to “tick this box.” But I am persuaded that the support for this concept is much more substantive than that. It reflects a recognition that a well-conceived lead director structure can provide many of the advantages offered by the separate chairman model—but with much less of an apparent departure from past practice.

If the combined CEO-chairman model is the starting point, adoption of the lead director model is clearly considered a more modest step than the election of a separate chairman. Some argue that the combined CEO-chairman model has produced good results for American companies and that drastic change is not required. Tom Neff of Spencer Stuart emphasizes both the record of generally ethical behavior of companies led by CEO-chairmen and what he regards as the lack of compelling evidence of economic gain associated with splitting the roles. My personal experience supports the argument that combining the roles in one person can work well, but the widespread adoption of the lead director model is evidence that many companies have come to see the need to move beyond sole reliance on one person to lead both the company and the board.[19]

As various surveys indicate, the specific responsibilities assigned to a lead director in the United States vary from company to company. However, they almost always include the following:

- Chairing meetings of all independent, “outside” directors
- Acting as the principal liaison between the independent directors and the chairman/CEO
- Helping to develop agendas for board meetings
- Monitoring the flow of information to the board
- In general, coordinating all aspects of the work of the board itself, including the work of the nominating/governance committee

More generally, the lead director serves as the point person to whom members of various constituencies can turn if they have a worry or a suggestion that they prefer not to take to the CEO in the first instance. If real trouble develops, the lead director can facilitate a thoughtful review of the performance of the CEO (if that is the issue) or can do whatever else seems appropriate to address a vexing issue or head off an impending problem. There is much to be said for having an authorized person within the organizational structure to whom directors can go to register concerns and check impressions. Appropriate use of the lead director model also can provide "ballast in turbulent times."[20]

Serving all of these functions obviously requires judgment and tact. The lead director must be careful not to suggest, by word or deed, that he or she is competing with the CEO for authority, is functioning in a managerial role, or is authorized to make decisions. One role that the lead director does not perform (that the separate chairman does) is to preside at meetings of the full board. This is a limitation of the lead director model; as the Katzenbach comment quoted earlier indicates, there can be real advantages to having someone other than the CEO chair board meetings. In any case, the lead director must have a quintessentially correct understanding of the difference between board oversight and day-to-day management. The CEO and the lead director need to work closely and comfortably together. They need to help each other, respecting their complementary roles.[21]

The potential consequences of failing to have either a separate chairman or a lead director are not good ones: suppressed concerns, sub-rosa grumbling, or the formation of informal cabals outside of regular channels. As I can attest from painful experience, the unstructured, informal way of dealing with contentious issues can entail high costs. In addition to aggravating people and encouraging divisions within a board, it also operates slowly and depends on the more or less accidental emergence of a director prepared to take the lead on a given issue. Counting on a spontaneously generated, ad hoc process to solve major problems is not sensible. A major responsibility, then, of a lead director is to function on standby, to be ready to provide leadership if the need arises. The lead director provides, as it were, an insurance policy on which the board prefers never to collect. A great virtue of this particular insurance policy is that it is cheap—precisely because such a person may also be helpful in quieter times, and may in fact assist in preventing the most serious kinds of crises from ever arising.

Five open questions about the lead director model remain to be discussed.

The first is whether the person should be called “lead director” or “presiding director.” I think that the term “lead director” is preferable, for the simple reason that the person in this position needs to do much more than simply preside at meetings of the independent directors. The phrase “presiding director” suggests too passive a role. To be sure, some worry that the term “lead director” may signify that the person in question is a superdirector, superior to all of his or her colleagues on the board, who might be tempted to regard themselves as merely rank-and-file members.[22]

My own thinking about anti-egalitarian connotations of the “lead director” terminology has changed over time. In earlier days, and especially in the context of my service on both the American Express and the Merck boards, I shared the view that it would be a mistake even to suggest distinctions among directors by using a title such as “lead director.” I now believe that both practices and attitudes have evolved sufficiently to reduce whatever discomfort the use of such a title may once have caused. There is more and more recognition that *boards really need someone to function as “lead” director*, and I think it is wise to have language reflect reality.

If the lead director is to substitute in at least some respects for a non-executive chairman, the role that the individual is being asked to play needs to be recognized explicitly. There is no reason to insist that all members of a board view themselves as the same in every way. Directors are the same in many respects (rights, fiduciary obligations, and standing), but they need not be the same in what they are asked to do—and often they will not be the same in what they are able to do. In any complex organization, some allocation of duties among individuals, taking account of differences in interests, experiences, and, yes, abilities, is entirely appropriate. As one commentator put it, if somewhat indelicately, “The good of the whole is more important than the tender feelings of the less able and most insecure.” I also believe that boards are now more able to accept whatever structure they believe is necessary to function effectively because board service is now less “club-like” than it used to be.

A second question is whether it is better to have many lead directors rather than a single lead director—the notion being that the particular individual acting as lead director can vary depending on the task at hand, whether it is nominating new directors, discharging the audit function, or setting compensation. Why not expect the director who chairs the relevant board committee to function as lead director? There is little doubt that the director who chairs a committee responsible for a specific topic should lead the discussion on that topic, but this does not obviate the need for an all-purpose lead director who can be called on no matter what the issue, and who can function as a kind of quarterback, distributing the “ball” to appropriate board colleagues in specific situations.

A third question is whether the responsibility of lead director should rotate among the directors. In principle, there is much to be said for some rotation. It is desirable that more than one board member have the opportunity to serve in this role, and it is also wise to avoid the risk that a longtime lead director (*the* lead director) and the CEO may, in the words of one commentator, “become too cozy.” Still, I think it would be a mistake to insist on a mechanical principle of rotation or to rotate assignments too frequently. Lead directors who serve for some reasonable period of time gain experience that is helpful, and both the CEO and the board are likely to be more comfortable if there is some continuity in the lead director position. Habits and styles naturally vary, and the CEO and the board should not have to cope with the “flavor of the month” too often.

A fourth question is whether a board committee, such as a committee on governance, acting through its chairman, can serve the functions of a lead director and obviate the need to name any individual specifically to this role. I used to believe that this committee approach was viable, and this model was in fact used reasonably successfully at Merck for some years. I am now persuaded that, for the same reasons that a lead director is preferable to a presiding director or to having many lead directors, having an individual explicitly assigned the role of lead director is superior to expecting the chairman of any single standing committee to attend to the duties of the lead director. The tasks to be performed inevitably extend beyond the mandate of even a broadly charged committee on governance.

The fifth and last question is the most difficult to answer: Will the lead director model become the established answer to the question of how the relationship between the board and its CEO should be structured, or will there be a further evolution in the direction of the split model, with a separate chairman?

Summing Up: Prospects for Organizational Change in the For-Profit Sector

My intuitive response to the last question is that the role of the lead director, now institutionalized, will become more and more consequential and that, in some number of instances, it will morph into the position of non-executive chairman. Whether or not this intuition is correct, I see absolutely no reason to believe that there will be any reversion to the old CEO-centric model. *The day of the imperial CEO is, and should be, over*. However well the model of a combined CEO-chairman with no lead director or other identified board leader worked at times in the past, it is inappropriate now.

My proposition is not that a pure CEO-centric model can never work—a statement clearly at variance with reality. Rather, the point is that the CEO-centric model is unnecessarily risky and suboptimal in other respects. In sum, it deprives the board, and the shareholders, of an important protection against abuses of power. In addition, it decreases the likelihood that the CEO (and all board members, for that matter) will hear the kinds of authentic second opinions that should be expressed freely in meetings of a truly engaged, independent board that knows it is accountable and feels comfortable debating key issues.

Companies need to have appropriate checks and balances in place in advance of difficulties. As already noted, this widely shared understanding has led to the near unanimous adoption by S&P 500 companies of a variant of the lead director or presiding director model. But this current "resting place" in the search for the best organizational structure need not be an end point. The conceptual arguments in favor of separating the roles of chairman and CEO when circumstances allow are powerful and create a strong presumption in favor of the separate chairman model.

With this presumption in mind, we need to ask whether, over time, the practical objections to splitting the roles can be overcome. These are my thoughts.

- The status issue is real, and great care should be taken not to offend the leader on whom the board and the shareholders must rely. But it should be possible to lean against the prevailing culture by seeking to separate the roles when the timing is right—especially when a new person is being made CEO.[23] Experience in other countries suggests that the status/culture problem need not be insurmountable. In addition, experience in the nonprofit sector in the United States suggests that competent leaders of complex organizations can be highly regarded, even if they are not expected to chair their boards. It will take time, perhaps a great deal of time, for assumptions about what is normal and expected in corporate America to erode, but boards should be willing to test the waters and, in the words of one commentator, "to chip away at the culture."

- The limited availability of talented individuals able and willing to serve as non-executive chairmen is an unfortunate reality. Boards should be more proactive in working to develop pools of candidates for the chairman role. I also suspect that some of those now serving as lead directors will become more comfortable, over time, with the idea of chairing their boards.
- Lead directors can make a great deal of difference in improving governance, but in my view it is a mistake to assume that having a lead director meets the company's full need for board leadership apart from that provided by the CEO. There is always a risk that a lead director will lapse into too passive a role. The very title of "chairman" carries an authority that, as several commentators have emphasized, just changes the board dynamic.[24]

There has been some movement, albeit modest, in the direction of the separate chairman model. The *Spencer Stuart Board Index* for 2006 reports that the number of S&P 500 companies with a combined chairman and CEO has come down to 67 percent from 74 percent in 2001, although in the majority of situations where the roles are split, the chairman was formerly the CEO. The report goes on to note that "158 companies have separated the role, compared with 140 last year. Of these,…48 have an independent chair [a chair who was not the former CEO or otherwise connected with management of the company], compared with 43 last year."[25] A 2007 Booz Allen Hamilton study reports that, over the last nine years, boards have been "increasingly splitting the roles of CEO and chairman."[26]

It would hardly be surprising if, among the ranks of the considerable number of companies that currently have a former CEO serving as chairman, there was some movement toward replacing former CEOs with more truly independent chairmen. If there is a greater willingness on the part of some corporations to try out the separate chairman model, a number of others might follow. The direction of change certainly seems clear.

What will happen, though, if inertia prevails? One commentator has suggested that there is at least some risk of rigid, mandated changes being imposed from outside the board—either by shareholder action or even by regulators or legislators who have concluded that the combined CEO-chairman model is fatally flawed.[27] "Once-and-forever" solutions are to be avoided because they deprive a board of the flexibility needed to respond to practical issues and implement whatever structure seems best suited to their specific situation.

This is precisely the thinking that led the Merck directors in 2005 to oppose a shareholder resolution that would have committed the board to separating the chairman and CEO roles on a permanent basis. The board's position was that it should have the freedom to ask the CEO to serve as chairman (supported by a lead director), to ask someone else to be chairman, or to find a third way—as, at this juncture, Merck did when it named a three-person executive committee to discharge what otherwise might have been a separate chairman's responsibilities.[28] Several years later (January 2007), when a new judgment had to be made about the leadership of the Merck board, the board decided that the CEO, Dick Clark, should be asked to serve as chairman as well as CEO, with the understanding that both the CEO and the board would benefit from the active involvement of an able lead director (Samuel Thier). This decision to recombine the CEO and chairman roles, while simultaneously establishing formally the position of lead director, was prompted by both the board's high degree of confidence in the abilities of Dick Clark, who has been outstanding as CEO, and the board's awareness that Clark's temperament and values reduced dramatically any risk that he would ever contemplate trying to function as an "imperial CEO." Circumstances vary, and providing some flexibility in settling on arrangements makes a great deal of sense.

Another significant question unaddressed thus far is why structural relationships between boards and their CEOs in the for-profit and nonprofit sectors have been so different in the United States for so long. The postscript that follows addresses this question. Reflecting on it may not only be of independent interest, but may also provide a sharper sense of how likely it is that the separate chairman model so prevalent in the nonprofit world will insinuate itself into more and more for-profit settings.

Postscript: Characteristic Differences in Board Structure between Nonprofits and For-Profits

In the nonprofit sector, a paid executive most often functions as CEO alongside a part-time, usually unpaid chairman, who is the leading “lay” trustee. An informal study of nonprofit organizations receiving grants from the Mellon Foundation revealed that the CEO was also the chairman in less than 10 percent of the cases. Most of the exceptions were foreign organizations, entities still led by their founders, or literary presses—which may have evolved only recently from for-profit status. Other exceptions are the National Academy of Sciences and the Institute of Medicine, as well as Princeton and Yale universities, where the president presides at board meetings.

Although nonprofit boards have numerous shortcomings, this is one respect in which customary arrangements work reasonably well most of the time. Before turning to the larger philosophical and historical forces responsible for the differences in typical leadership structures, however, we should recognize two problems that are at least somewhat peculiar to the nonprofit world.

First, the danger that a board chairman will act like management is appreciably greater in the nonprofit sector than in the for-profit sector. In his widely quoted 1985 speech on governance, Ken Dayton remarked, “I regret to tell you that I have known volunteer chairmen of the [nonprofit] board who clearly think that they are the CEO. And, even more I regret to tell you, I have known paid executives who ought to be the CEO but who are not, and who are perfectly willing to let the board and/or its chairman call the shots.”[29]

Part of the explanation for such behavior is, I suspect, the sometime tendency for boards of nonprofits—lacking shareholders and freer from some of the other external constraints that operate in the for-profit world—to believe that they are accountable only to themselves. The solution to such problems lies in the recruitment of stronger executive leadership and an insistence on having boards that understand the boundaries implicit in their oversight roles. But there are also situations in which the chairman is just too intrusive and too inclined to function in a managerial role. One experienced nonprofit trustee, Barbara Robinson, has observed that the worst offenders tend to be current or former CEO-chairmen from the for-profit world, who bring typical for-profit behavior with them to the nonprofit world.

An additional problem is that nonprofits sometimes do not pay enough attention to the selection of the chairman and to ensuring that the chairman and the CEO are compatible. Let me cite two examples based on my personal experiences:

- Years ago, Fred Friendly of the Ford Foundation founded the TV program Public Broadcasting Laboratory (PBL). In the process, he appointed separately an executive director (Av Westin) and a board (chaired by Edward Barrett, former dean of the Journalism School at Columbia), on which I also served. The board was not given the opportunity to decide if it thought Westin was the right leader for this pioneering enterprise, and Westin was not given the opportunity to think about whether he could work effectively with the board that Friendly chose. As it turned out, there were real differences of philosophy and working styles between the executive director and the board, and the result was confusion and wasted effort. Eventually the board sent a delegation to see Mac Bundy, president of the Ford Foundation, to explain that the situation was unworkable and that either the executive director or the board had to be changed. Shortly thereafter, a new executive director was named. Although it may be easy, in retrospect, to understand why Friendly's enthusiasm for his project caused him to move ahead without thinking about the relationship between the CEO and the board, the lesson is obvious: there needs to be reasonably clear agreement between the board and the CEO as to mission and operating philosophy. The two should never be chosen independently.
- When I was elected president of the Andrew W. Mellon Foundation in 1988, the chairman at the time, William O. Baker, with whom I had a splendid working relationship, informed me that he was about to retire. The senior member of the board of trustees told me that he expected to succeed Baker. Although the trustee in question was a fine person, it was evident that we would have difficulty working effectively together. I spoke with one or two other trustees and then decided, with their encouragement, to take a major risk: to go out on my own

> initiative and identify from outside the board a person who, if elected by the trustees, would make a superb chairman and with whom I was confident I could work well. Fortune smiled on me, and I was able—with the help of Paul Mellon—to persuade John C. Whitehead, who was just stepping down as deputy secretary of state, to stand for election as chairman of the board of the foundation. Whitehead's status, professional qualifications, and personal qualities made his election a foregone conclusion.[30] It would have been easy for me to simply let nature take its course in the selection of a chairman following the retirement of Baker—and it would have been a huge mistake.

The much larger and more fundamental question is what explains the basic differences in how the nonprofit and for-profit sectors in the United States typically structure relationships between the CEO and the board. More specifically, given the prevalence of the combined CEO-chairman model in the for-profit world, why do the CEOs of nonprofits so rarely chair their boards?

First, leadership structures in much of the nonprofit world owe a good deal to the long-recognized needs of most of these organizations for generous external patrons. Managements of nonprofits simply could not survive on their own—as most managements of businesses did prior to the separation of ownership and management. The existence of lay boards of trustees for colleges, museums, and hospitals has a venerable history, which is tied to the American traditions of voluntarism and strong private-sector support of such activities. Unpaid volunteers often founded nonprofit entities, and it is hardly surprising that they have continued to play major roles in governance.

Second, the public in general may be more than mildly skeptical about the capacity of nonprofits to govern themselves. Many nonprofits reflect the interests of individuals who are idealistic, committed to a set of nonmonetary goals, and generally less experienced in some kinds of practical work than are those who live principally in the business world. These are stereotypes to be sure, but to the extent that the generalizations hold, nonprofits need both the help and the stamp of approval that can be provided by the active presence on their boards of prominent business leaders, investors, lawyers, and statesmen—with one such person usually serving as chairman. Potential donors may want assurances that boards are led by responsible, well-respected outsiders, who can be counted on to be sure that funds are invested wisely, that proper accounting practices are followed, and, in general, that the enterprise is conducted in predictable, certifiable ways.

Third, the distinctive missions of nonprofits have strong implications for organizational structure. In the case of colleges and universities, for example, the central importance of academic freedom and of academic judgments constrain the roles played by the president, other officers, and trustees. In such a setting, it is easy to see why a regularized, highly structured, CEO-centric model of governance has little relevance. More generally, the broadly collegial character of many nonprofits implies the need for a strong external presence on boards. In most nonprofit organizations, it is assumed that many of the professionals on the staff (the faculty at a university, the curators at a museum, the doctors at a hospital) owe allegiance to their professions as well as to the particular institution for which they work.[31]

These considerations help explain why the key actors in a nonprofit enterprise are usually comfortable with a strong outside chairman and why it makes sense to rely on the board itself and the institution overall, not on the CEO, to provide continuity. Heads of nonprofits such as universities and hospitals are accustomed to working with faculties and groups of doctors; they are used to sharing power and to operating within complex decision-making structures where there is much sharing of authority.

For-profit entities, in sharp contrast, often originated as creatures of either entrepreneurs or strong-willed managers and investors, and many evolved from family businesses. Internal “directors” were natural, since they were the ones who understood the business and had to run it. Their money and their futures were at stake. One can see why there would have been less of a sense of public accountability associated with business enterprises—and less reason to engage outsiders in overseeing their affairs.

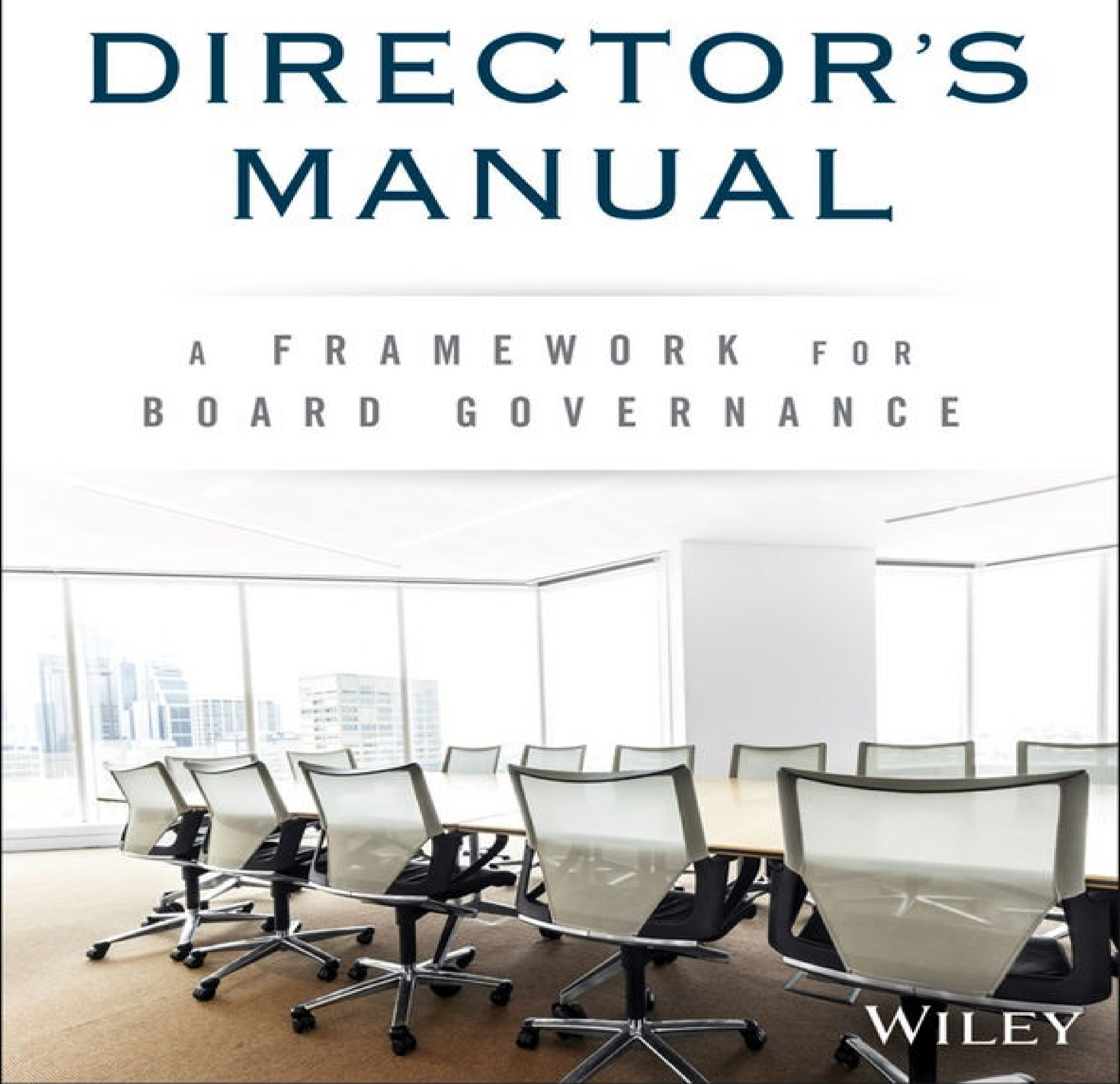
Times have changed, and we forget too easily that today’s emphasis on the outside director is relatively new. It reflects major shifts in patterns of ownership, and especially the rise of the large institutional shareholder. As we see from the current debate over how to nominate and elect directors (discussed in Chapter 6), we are still trying to find the best ways to reflect legitimate shareholder interests in the oversight of large companies. Some practices already common in the nonprofit world could prove useful to businesses as they seek to cope with this evolutionary process, and to find the right balance between the need for crisp decision making and the need for oversight.

My expectation is that businesses will continue to learn from their nonprofit cousins, even as we recognize that the precise organizational forms that have worked in the nonprofit sector will not be carried over, without modification, to the corporate sector. As I will say again at the conclusion of this book, differences in mission between the sectors are both profound and consequential.

PETER BROWNING AND WILLIAM SPARKS

THE DIRECTOR'S MANUAL

A FRAMEWORK FOR BOARD GOVERNANCE



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PREFACE

Each corporate board has its own unique culture, created by the mix of directors, the personality and style of the CEO, and the culture of the company. Boards operate within this context to fulfill their fiduciary duties to shareholders while at the same time satisfying growing regulatory reporting requirements and regulations. It's a balancing act that is difficult at best.

The Director's Manual provides a proven, flexible framework to help boards of directors meet these challenging requirements while allowing each board to do so in the context of its own unique culture and business demands. The framework offered in this book provides guidance that is well suited for both established and new boards as they convene members and establish themselves within an organization.

Help is provided with regard to all aspects of board governance, including the role of the board, board schedules, dealing with a disruptive director, member selection, advice on management of group dynamics, and the creation of high-performing boards. Further guidance is contained in a comprehensive set of board and director assessments and a proprietary assessment (Board Culture Profile) that measures the most important determinant of board performance: group culture.[1]

Why We Wrote this Book

The impetus for writing the book was rooted in both our interest in, and our experience with, board governance, and the increasing scrutiny of shareholders and shareholder activists in board structure and performance. We believe this book will be an essential educational and practical resource for both current and aspiring directors, since it blends leadership and research findings on organizational dynamics with practical, straightforward advice for corporate directors, along with a solid set of how-to best practices.

Corporate boards are influenced by the prevailing corporate governance climate outside the boardroom. If the economy is booming, unemployment is low, and the country's confidence is high, then a board's set of priorities and options are likely to be very different from those in times of economic and social uncertainty.

Although this may seem to be an obvious connection, most resources concerned with board governance don't fully explore the impact of this symbiotic relationship between the world inside the corporate boardroom and the realities of the world outside the boardroom. And, even when the impact of this board and real-world relationship is covered in these resources, little practical advice and useful tools are offered.

The Director's Manual directly addresses this information shortfall by providing governance guidelines that are not only clear and concise but also immediately applicable to every board type and environment.

Note

[1] Sparks, William, “Group Culture Assessment Scale” (PhD diss., The George Washington University, 2002).

CHAPTER 1
THE CHANGING WORLD OF BOARD GOVERNANCE
HOW WE GOT HERE

What's in This Chapter?

- How and Why Boards Have Changed
- A Barometer for CEO Compensation
- Why Pay Ratios Have Changed Radically
- A Board Governance Tipping Point
- Impact of the 2008 Financial Meltdown
- Chapter Summary and What's Next

One of the principle tenets of our consulting work is that every board is operationally and culturally unique. It is this simple fact that makes constructing a single, all-inclusive set of board governance best practices an impossible task. Therefore, the guidance in this book is not positioned as a set of “hard and fast” rules or universally applied “must have” characteristics. Rather, the guidance is based on a flexible framework approach that allows boards to meet their fiduciary and governance duties while remaining responsive to the real cultural dynamics that directly influence the quality and consistency of decision making.

A framework approach also has a second advantage: it allows boards to respond appropriately to an ever-changing external socioeconomic and political landscape. This is an important point, since society's swiftly moving cultural currents, along with the ebb and flow of an economy's strength, has a profound impact on the performance expectations of corporate boards. Of course, this is no grand revelation to anyone reading this book, but we believe these concepts are important to keep in mind as context for the board governance recommendations made in the pages that follow.

How and Why Boards Have Changed

If you were asked to make a list of the most important game-changing events or trends that have profoundly impacted the U.S. economy and culture in the last sixty-five years, the list that you would make would likely include at least the following:

- A move away from a manufacturing economy to a service economy following decades of dominance in the post–Second World War global economy.
- Improvements in automation and the manufacturing process of the 1970s and 1980s. It was a trend that further undermined the manufacturing sector over the years as computer-driven machinery and tools (robotics, CAD-CAM design tools, etc.) replaced individual workers. Global competition also slowly eroded the U.S. manufacturing base as more and more manufacturing jobs moved to countries outside U.S. borders with lower labor costs.
- The diminishing influence and power of organized labor's ability to guarantee members a lifetime of a steady, living wage and a fully funded, secure pension upon retirement.
- The “creative destruction” of industries in the 1980s brought about by the world of leveraged buyouts and a ruthless cadre of “corporate raiders” who broke up many marquee old-line companies and sold off the divisions to score huge profits for themselves.
- The dot-com bubble that began its rise in the early 1990s and continued throughout the decade until it popped, to a devastating effect, in 2001. Investment strategy at the time was a race toward unrealistic valuation. Investors were willing to fund nearly any technological start-up venture even if it lacked a viable business plan. It is interesting to note that this investment setback did little to cloud the financial community's continued unrealistic economic outlook. In fact, this unsound enthusiasm in the marketplace was encouraged in large part by favorable economic policies of the federal government, supported by a period of low inflation due largely to lower cost of goods from China and a continuing worldwide technological revolution.

- The impact of blatant corporate malfeasance in 2001, exemplified by three highly visible corporations at the time: WorldCom, Enron, and Tyco. It was a revelation that rocked both the investment community and individual stockholders. Again, high-flying investors and shareholders lost millions of dollars when these companies declared bankruptcy (Enron Corporation declared bankruptcy in December of 2001), a singular action that further exposed an underbelly of lies and deceit that had pervaded these organizations at the very top and eventually put thousands of ordinary workers out on the street without jobs or their life savings.
- Finally, the 2008 huge financial meltdown and the economic panic that followed. It was a time of fear and shock as we watched once powerful brokerage houses as well as large banks and old-line industrial giants teeter on the brink of declaring bankruptcy. It took massive, last-minute, stopgap federal cash infusions to save the world's economy and to shore up institutions that were deemed “too big to fail.”

Why These Events are Important

The reason for noting these historical and societal events is twofold. First, it demonstrates how past events impact the current expectations placed on corporate boards; and second, it establishes the contextual "waters" for the operational strategies, policies, and procedures that most boards follow today. This chapter will focus on two specific trends that grew out of these economic and social gyrations:

- Ever-increasing chief executive officer (CEO) compensation (see Figure 1.1).
- The impact of a 2002 change to the New York Stock Exchange (NYSE) Listed Company Manual that required "non-management directors to meet at regularly scheduled executive sessions without management." While this change to the NYSE Listed Company Manual (303A.03) occurred during the same time period as the passage of the 2002 Sarbanes-Oxley Act (Congress's response to public outrage over Enron's corporate malfeasance and greed), the fact that the two actions occurred at the same time is a coincidence of timing. The fact is, as important as the Sarbanes-Oxley legislation has been to curbing illegal corporate activities, we would argue that the NYSE Listed Company Manual change has ultimately produced the most far-reaching impact on board governance, performance, and effectiveness.

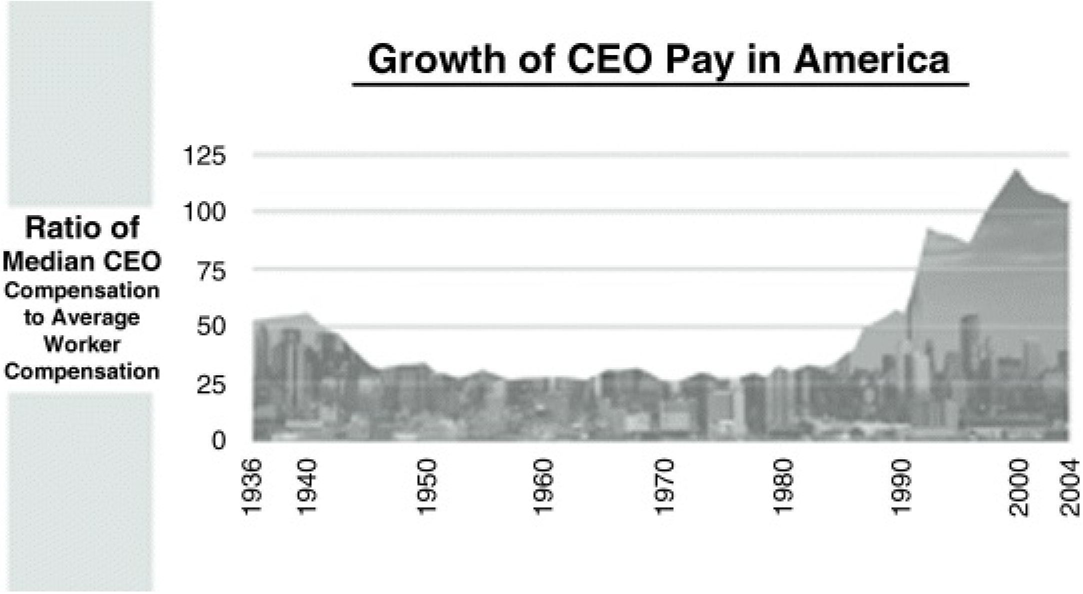

Figure 1.1 History of CEO Pay

Source: **Peter Browning Partners**

A Barometer for CEO Compensation

According to Carola Frydman and Raven E. Saks, authors of “Historical Trends in Executive Compensation 1936–2003,” CEO compensation experienced three distinct phases over the last seventy-five years: World War II, the mid-1940s to the 1970s, and the 1980s through the 1990s.[1]

Prior to World War II, the median executive compensation was about fifty-six times higher than average wages, although CEO compensation did decline sharply during World War II. After the war the U.S. economy experienced a period of unfettered growth and development. This expansion created a rapidly growing middle class that was confident about lifelong careers with the same company, steadily rising wages, and opportunities for career advancement. All of this confidence brought with it a predictable stream of disposable cash to buy American products.

Interestingly, executive salaries during this period of expansion remained relatively low and, in fact, slowly fell until 1970, when they reached a low point of twenty-five times average wages. During this period organizations promoted their most senior and capable executives to the CEO spot and then compensated them with a salary, cash bonuses, and limited stock options. As a rule, these groomed CEOs kept their jobs until retirement.

Global Competition Brings Change

Global competition in the 1970s imposed new economic pressures on corporate America. Nations previously ravaged by war, especially Japan, took full advantage of industrial redevelopment support from the United States. Soon these countries began to compete directly with their benefactor, especially in the car and consumer electronics markets. This competition resulted in the closing of many U.S. manufacturing plants, and once thriving towns, cities, and communities, and even whole regions, were economically decimated. All of this upheaval and uncertainty in the manufacturing sector from mid-1970 to the end of the 1980s resulted in a 2,000 percent increase in merger and acquisition activity (as compared to previous years) as companies struggled to keep control of their organizations and to avoid the ravages of a hostile corporate takeover (Gladwell, 2009).[2]

The Impact of Strategic Planning

Beginning in the early 1980s, CEO compensation policy began to radically change as U.S. corporations switched their focus to long-term strategic planning models and away from more traditional, short-term business planning approaches. This was a change in thinking that directly impacted corporate board management and its priorities.

A key proponent of this long-term strategic planning approach was Bruce Doolin Henderson, who in 1963 founded the Boston Consulting Group. Corporate leaders, including General Electric's CEO Jack Welch, became disciples of the approach in the early 1980s, as did many university business schools and scores of consultants who were eager for the business opportunity created by Henderson's ideas.

In his 2010 book, *The Lords of Strategy: The Secret Intellectual History of the New Corporate World*, which is about Henderson's influence on business practices worldwide, author Walter Kiechel notes that Henderson literally “changed the world.” “Few people,” Kiechel says, “have had as much impact on international business in the second half of the twentieth century.” (A complete account of this industry-changing consulting group can be found in *The Lords of Strategy: The Secret Intellectual History of the New Corporate World*.)[3]

The Impact of Long-Term Incentives

The shift to corporate strategic-planning practices not only created a multibillion-dollar consulting industry but also set the groundwork for a new way to compensate CEOs and other top corporate executives. Now, instead of traditional compensation packages (i.e., salary, cash bonuses, and limited stock options), corporate boards had a range of pay strategies that mirrored these emerging long-term business planning strategies. CEO pay packages soon included long-term incentives (LTI) that tied a CEO's overall pay to the long-term performance of the company (typically, three years).

These changes to the traditional rubric used to calculate CEO compensation occurred just as investors and other financial community movers and shakers began to demand that companies produce higher profits within ever-shorter time lines. The pressure behind these short-term profit demands resulted in great measure from the dissolution of traditional pension plans and the significant expansion of mutual funds. These various funds competed with one another for shorter-term performance increases.

According to a recent article in *Foreign Affairs* magazine by Jerry Z. Muller, a history professor at The Catholic University of America, the hypercompetitive 1980s resulted in “companies (as well as various public-sector organizations) attempt[ing] to shift the risk by putting their pension funds into the hands of professional money managers, who were expected to generate significant profits.” The result of this strategy, according to Muller, was that “retirement income for employees [was] now depend[ent] . . .on the fate of [the employee's] pension funds. “The change had the practical result of putting even more “pressure on corporate executives to produce short-term performance results.”[4]

The shorter time line to increase profits also had an unfortunate downside: it created a temptation among fund managers, corporate CEOs, and others at the corporate top to boost immediate profits at the expense of longer-term investments, such as research and development or improving workforce skills.

Phase Three—The Results of Uncertainty

The final phase of Frydman and Saks's executive compensation development framework extended through the 1990s. It was a time when many CEOs lost their jobs because the company's promised performance failed to square with the company's earnings reality or because of increased merger and acquisition activity. The employment uncertainty led boards to offer highly sought after CEOs and their teams a “change of control agreement” (also known as a “golden parachute”) in their employment contracts. This practice grew to such a degree that the Internal Revenue Service (IRS) responded in 1984 with new rules that capped these payments at 2.99 times the average of the last five Form 1099 income filings by the CEOs. Any income in excess of this amount would now be subject to a nondeductible 20 percent excise tax.[5]

By the late 1980s, companies began offering stock options (LTIs) stock options in lieu of cash for LTI payments as public sentiment (and pressure) believed these rewards would be more aligned with shareholder value.

Soon, the stock benefit alone began to make up almost half of high-level managerial pay (Frydman and Saks, 2007), a state of affairs that only served to increase the CEO/worker wage gap as stock values soared during the period's bull market. As noted even in Graef Crystal's 1991 book, *In Search of Excess: The Overcompensation of American Executives,* the preceding twenty years had seen CEO pay increase by more than 400 percent while the typical American worker's wages remained stagnant.[6]

In 1993, in response to investor complaints, Congress enacted Internal Revenue Code Section 162(m), which caps a public company's corporate income tax deduction at $1 million per year for each of its top executives. The provision did, however, include an important exception in the case of preapproved, performance-based compensation plans, a “loophole” that allowed the continued growth of long-term executive pay and bonuses. Clearly, this was not the original law's intention. Nor was it the lawmaker's intention to allow the value of stock option grants to CEOs of the S&P 500 firms to leap by 45 percent on average (during the law's first year in effect) and then to nearly double over the next two years. As the chairman of the Securities and Exchange Commission (SEC), Christopher Cox noted in an article by Mark Maremont and Charles Forelle in the December 27, 2006 edition of the *Wall Street Journal*, that the 1993 law “deserves pride of place in the Museum of Unintended Consequences.”[7]

Even the end of the great 1990s dot-com bubble did nothing to slow the rise of executive compensation. By 2005 the gap between executives and workers expanded even further, and by 2005 an executive in our study earned 110 times an average worker's earnings—about twice the corresponding ratio prior to World War II. Due to the generous use of stock options as compensation, some top executives would eventually earn more than 700 times the pay of an average worker (Frydman and Saks, 2007).[8]

2002—A Board Governance Tipping Point

Interestingly, a pivotal change in board governance occurred during the market upheaval of the post-dot-com era. In 2001 employees at communications firm WorldCom, electronics and home security company Tyco, and energy giant Enron Corporation all were caught up in an episode of unparalleled corporate malfeasance. Enron's criminality was particularly egregious in the behavior of employees of certain prominent business partners—in particular, employees of the Chicago-based accounting firm, Arthur Andersen. At the time Arthur Andersen was one of the five largest audit and accountancy partnerships in the world.

Despite a one-hundred-year record of service and its business community prestige, the “Enron scandal” destroyed the venerable accounting firm. Arthur Andersen lost its Certified Public Accountant license in 2002 and quickly disappeared from the scene. Enron filed for bankruptcy in 2001, and many of its top executives were charged, convicted, and served prison time for their role in the scandal.

The fallout from these highly publicized events was a great deal of public and private scrutiny on boards of directors serving in publicly traded companies. In 2002 Congress enacted a new law, Sarbanes-Oxley (also known as the Corporate and Auditing Accountability and Responsibility Act), designed to address future corporate accounting integrity breaches.

Key Provisions of the Sarbanes-Oxley Act

Each of the eleven titles (or sections) of the Sarbanes-Oxley Act (SOX) mandates specific financial reporting requirements that are intended to curb financial fraud and to increase financial reporting transparency.

SOX legislation was a direct response to revelations in the early 2000s of accounting fraud that was perpetrated by Enron, Tyco, and WorldCom.

Five of the eleven Sarbanes-Oxley provisions are associated with major points that we make in this book, including the following:

- Section 320 focuses on statutory reports to include certifications.
- Section 401 focuses on the accuracy of financial statements.
- Section 404 is associated with the adequacy of internal control structure and procedures.
- Section 409 concerns public disclosure of significant changes in a company's financial condition.
- Section 802 outlines penalties for destroying or falsifying records to obstruct or impede an investigation.

The law's intent was to strengthen the integrity of internal reporting by requiring top management to personally certify the accuracy of key financial information and by imposing severe penalties for fraudulent activity. The Sarbanes-Oxley Act also increased the independence of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors.

The Most Impactful Governance Change

While some would suggest that our current board governance environment is a result of the Sarbanes-Oxley Act, that assertion would be only partially true. Certainly, the Sarbanes-Oxley Act has had a profound impact on the internal reporting requirements of corporations. In particular, there are five key sections of the legislation that are associated with the major points that we make in this book. The first is Section 320, which is focused on statutory reports to include certifications; the second, Section 401, is focused on the accuracy of financial statements published by issuers and requires that they be presented in a manner that does not contain incorrect statements or admit to stating material information. The third, Section 404, is concerned with requirements for issuers to publish information in their annual reports concerning the scope and adequacy of internal control structure and procedures. The fourth section, Section 409, requires issuers to disclose to the public, on an urgent basis, information on material changes in their financial condition or operations. Finally, Section 802 is a provision that imposes penalties or fines and/or up to twenty years' imprisonment for altering, destroying, mutilating, concealing, and falsifying records to obstruct or impede an investigation.

However, the pivotal change that would forever change the landscape of corporate boards took place on August 1, 2002. That's when the NYSE Board of Directors approved and submitted to the SEC for approval a revision to their Listed Company Manual that recommended, among others, the following corporate board guidelines:

- A majority of corporate board members must be independent; that is, they cannot have any material interest in the corporation.
- Independent directors are the only voting members of the board.
- Boards must have a minimum of three standing committees: audit, compensation, and governance/nominating.
- Boards must conducting annual assessments of the CEO, the board itself, and each of the three standing committees.
- Independent directors must meet periodically in executive session without company management being present.

Of all the Listed Company Manual changes approved by the NYSE, the last one requiring the independent directors to meet without the CEO represents a sea change in the world of board governance. Prior to this change, CEOs never would have allowed this meeting to take place, and with good reason; you never knew what might be discussed in the meeting, including a CEO's performance and compensation. We discuss this important change in more detail in Chapter 3, “Key Board Leadership Roles,” along with the many implications that this change has had on board governance activities.

Other Important Governance Changes

Another important change to the world of board governance occurred in April 2003, when the SEC implemented rule 30b1–4 that required registered management investment companies to disclose their proxy voting policies and voting records. Although this ruling might appear to be fairly straightforward, the practical impact of implementing it certainly was not. At the time of the ruling, mutual funds represented 18 percent of all publically traded U.S. corporate equity (about $2 trillion of value). Suddenly, those who managed these large funds were required to vote on every proxy matter. This meant that the managers would have to understand hundreds, if not thousands, of proxy votes and cast votes appropriately.

The solution to this dilemma was essentially to outsource this work to proxy advisory firms, principally to Institutional Shareholder Services (ISS), a firm founded in 1985 by shareholder activists Robert Monks and Neil Minnow. The purpose of ISS originally had been to promote good governance and to raise the level of active and informed proxy voting among institutional investors. However, by 2006 opinions about ISS on proxy votes began to have considerable influence on the final outcomes of proxy voting. A 2006 article by Robert D. Hershey Jr. in the *New York Times*, titled “A Little Industry with a Lot of Sway on Proxy Votes,” provided good evidence of this influence. The article noted that by the firm's own estimate ISS opinions affect the governance decisions of a cadre of professional investor's controlling $25 trillion in assets, a figure that encompasses half the value of the world's common stocks.[9] As aptly characterized by David W. Smith, president of the Society of Corporate Secretaries and Governance Professionals, “the influence these advisors wield is extraordinary.”[10]

Key Provisions of the Dodd-Frank Act

Dodd-Frank (or The Dodd-Frank Wall Street Reform and Consumer Protection Act) was passed by the Obama administration in 2010 in response to the 2008 financial crisis. It is a complex piece of legislation that is intended to prevent the particular set of circumstances that nearly crashed the world economy in 2008.

The act covers sixteen major areas of reform, ranging from consumer protection, to preventing abusive lending and mortgage practices by banks, to ensuring that financial institutions will never again be “too big to fail.”

Dodd-Frank, named after its sponsors, Senator Christopher J. Dodd (D-CT) and U.S. Representative Barney Frank (D-MA), also created various councils and oversight agencies that are charged with ensuring that the aims of the legislation are realized. Since these mechanisms are complex and often controversial, many of them are still being implemented. Here are some of the major provisions of the legislation:

- Creation of the Financial Stability Oversight Council (FSOC) to monitor the overall risks in the financial industry (including hedge funds). The council's members include the Federal Reserve, the SEC, and a newly formed agency called the Consumer Financial Protection Bureau (CFPB) that is intended to protect consumers from “unscrupulous” business practices by banks.
- Dodd-Frank also mandated that the riskiest of investment instruments, such as credit default swaps, be regulated by the SEC or the Commodity Futures Trading Commission (CFTC). Insurance companies were also targeted by the legislation, and a new Federal Insurance Office (FIO) was set up to determine if the largest of these companies might be a potential risk to the system. Insurance underwriter AIG needed an $85 billion federal bailout to stay in business in 2008.
- An Office of Credit Rating was created at the SEC to ensure that credit ratings agencies such as Moody's and Standard & Poor's do a

better job of monitoring and recommending investment tools.

On June 30, 2014, the SEC, responding to a rising chorus of complaints about the outsized influence of ISS and other proxy voting entities such as Glass Lewis, published a ruling entitled “Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms.” Specifically, the ruling noted that “the proxy Voting Rule does not require that investment advisers and clients agree that the investment adviser will undertake all of the proxy voting responsibilities.”[11]

The ruling has pushed large institutional investors to develop their own capabilities for the determination of what votes to cast on a particular proxy matter. For example, BlackRock, the largest manager of money, just recently published its own 2015 proxy voting guide.

Impact of the 2008 Financial Meltdown

The financial crisis of 2007–2008 was the worst financial crisis since the Great Depression in 1929, and it threatened to completely collapse the American banking system. In large measure the collapse was caused by a housing bubble that peaked in 2006 as a complex system of subprime mortgages and questionable trading practices was revealed and the whole house of cards quickly crumbled.

One of the most notable events was the failure of Lehman Brothers. Before declaring bankruptcy in 2008, Lehman Brothers was the fourth largest investment bank in the United States. A court-appointed examiner later found that the bank had moved $50 billion of bad investments off its balance sheet each quarter to hide its actual financial condition. Like the Enron scandal, Lehman Brothers' fall was seen by stockholders as another example of corporate America's failure to monitor itself.

As if the country needed another example of financial malfeasance, the Bernie Madoff scandal also surfaced in 2008. Madoff was the founder of a Wall Street investment firm, Bernard L. Madoff Investment Securities. Madoff eventually admitted that his Ponzi scheme had defrauded thousands of individual and institutional investors out of more than $64 billion. Madoff is now serving a 150-year prison sentence for his crimes.

Federal Bailout

As a result of these scandals and associated regulatory failures, the economy spiraled dangerously toward economic depression, and trust in the stock market and in big business plummeted as quickly as unemployment rose. Finally, the U.S. government played the only hand that it had in the game and pumped more than $750 billion into the largest “too big to fail” financial institutions through the Troubled Asset Relief Program (TARP). The government also loaned about $110 billion to the auto industry to keep it afloat, with a majority of the relief going to General Motors and Chrysler.

Multiple factors contributed to the 2008 financial crisis. The U.S. Senate's Levin–Coburn Report, the product of a two-year bipartisan investigation by the U.S. Senate Permanent Subcommittee on Investigations into the origins of the 2008 financial crisis, noted that the crisis was the result of “high risk, complex financial products; undisclosed conflicts of interest; the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street.” Others would argue that the 2008 financial crisis was another example of corporate greed and a failure of corporate boards to control excessive executive compensation.

While there might be debate about the causes of the financial crisis, the Dodd-Frank Act (named after Senator Christopher Dodd and U.S. Representative Barney Frank), which was signed into federal law by President Barack Obama in July 2010, was very clear about the legislation's intention in its preamble. The act states that its purpose is to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”

The Dodd-Frank legislation brought about the most significant changes to financial regulation since the financial reforms enacted following the Great Depression. In addition to curbs on the types of trading activities that financial institutions would be allowed to practice, the legislation gave additional powers to shareholders. The changes represented a seismic shift in this fundamental relationship. Among other provisions, the SEC was asked to grant shareholders the right to provide a nonbinding advisory vote, a “say on pay” for executive compensation.

Although the vote is not binding, directors are now required to regularly (annually, biannually, or triennially) submit to shareholders an advisory vote on the prior year compensation for the NEOs (named executive officers). If the affirming vote is less than 70 percent, then it may indicate that a problem exists in the correlation between the CEO's pay and the Total Shareholder Return (TSR) ratio of the company. This score is also a metric that ISS and other proxy services track and use in their evaluation of individual companies. Although the number of negative votes remains quite low, it does keep attention focused on this issue.

The other significant outcome from the Dodd-Frank Act is just beginning to unfold. The legislation called for changes aimed at better shareholder access. Specifically, it asked for a process to provide shareholders the ability to place candidates beyond those proposed by the board on the company's annual proxy list of candidates.

Although the regulation proffered by the SEC was contested and eventually dropped, no resolution is at hand. Shareholders are still asking for such a proviso to be placed on the proxy list for a shareholders' vote. Some companies, such as GE and Bank of America (among others), changed their bylaws to add this feature while others are dealing with it in their annual meeting. For example, the May 18, 2015 issue of the corporate board publication *Agenda* noted that “the most popular shareholder proposal topic this year has been proxy access, increasing fourfold from last year.”[12]

Chapter Summary

This chapter supports the board governance recommendations that we make later in this book by highlighting the major social, economic regulatory changes that contribute to today's board culture and practices. Specifically, this chapter makes the following key points.

CEO compensation continues to increase, despite increasing public attention to the gap between average worker and CEO compensation. This wage gap has increased from a low of twenty-five times that of an average wages to many multiples of that ratio, although the average gap generally caps at about 350 percent that of an average worker's wages in the company.

Clearly, this is an issue that will not disappear anytime soon. At the same time, the emphasis on pay for performance is showing results. In May 2009 *Forbes* published an article by Emily Lambert titled “The Right Way to Pay,” highlighting a move toward “pay packages that reward long term performance rather than short term greed.” Importantly, 3,422 companies held “say on pay votes” in 2014, in which only 66 companies failed (1.9 percent).[13]

As a May 17, 2015 article, “It's (Still) Their Party,” by David Gelles in the *New York Times* said about this issue on their annual survey of CEO compensation, “this apparent satisfaction with pay may be a result of the rising stock market. Shareholder dissent, when it does crop up, typically occurs at companies that have awarded lush compensation even as their performance has lagged. Investors watching their shares go up are less likely to be outraged by a sizeable bonus or stuck grant.”[14]

Although the most visible legislative result of the “Enron scandal” is the Sarbanes-Oxley Act, aimed at the accounting abuses at the root of Enron's corporate malfeasance, the most important rule change impacting board governance occurred in 2002, when the NYSE Board of Directors approved and submitted to the SEC for approval a revision to their Listed Company Manual, recommending that independent directors must meet periodically in executive session without company management being present.

Of all the Listing Company Manual changes approved by the NYSE, this is the most important action taken, and it represents a sea change in the world of board governance.

The Dodd-Frank Act is a consumer protection act signed into federal law by President Barack Obama in July 2010, which restricts the types of trading activities that financial institutions are allowed to practice. The law was enacted in response to the 2008 financial meltdown that nearly sent the United States and the world into a 1929-type depression. The Dodd-Frank legislation, among other consumer protections, gave shareholders the right to provide a nonbinding advisory vote, or a “say on pay,” for executive compensation.

What's Next?

Chapter 2, “Role of the Board,” offers some guiding principles for effective board governance. The chapter uses the story of the rise and fall of former Home Depot CEO Bob Nardelli to illustrate a cautionary tale for boards considering going outside the company to hire their next CEO. The story also supports two key principles: first, boards do not run companies; second, there are serious consequences in making the wrong choice of a CEO, and there is transformative power in making the right choice of a CEO.

Notes

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11. Securities and Exchange Commission, “Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms,” June 30, 2014. Accessed August 1, 2015, www.sec.gov/interps/legal/cfslb20.htm.

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CHAPTER 2
ROLE OF THE BOARD

What's in This Chapter?

- Home Depot's Leadership Question
- Two Key Guiding Principles
- Why Boards Exist
- Three Critical Questions That Boards Ask:

  Does the Company Have the Right CEO?

  Is a Robust Succession Plan in Place?

  Is the Company Following the Right Strategy?
- Chapter Summary and What's Next

The Home Depot, the ubiquitous DYI (Do It Yourself) retailer, opened its first two cavernous 60,000-foot warehouse stores in Atlanta, Georgia, in June of 1979. At the time the concept of a one-stop home improvement store that focused on helping home project warriors refurbish bathrooms, replace doors and windows, build toolsheds, and complete a thousand other DYI projects clearly filled a marketplace niche. By 1989 the company had opened its 100th store, and by 1984 the company was listed as a publically traded company on the New York Stock Exchange (HD).

From the beginning, company founders Bernie Marcus and Arthur Blank credited Home Depot's success on a focus on superior customer service provided by trained and knowledgeable associates who are able to offer on-the-spot assistance for almost any home project. This people-focused philosophy was at the center of the vision that Home Depot's founding team had for the company, which also included investment banker Ken Langone and merchandising star Pat Farrah.

Throughout the 1980s and 1990s, the company grew at a brisk pace, making strategic acquisitions along the way. In 1994 Home Depot acquired Aikenhead's, a chain of Canadian home improvement centers, and in 2001 it acquired Total HOME, a Mexico-based home improvement center. In 2006 Home Depot extended its reach into the international market with the acquisition of the Chinese home improvement chain, The Home Way.[1]

Home Depot's Leadership Question

In 2000 Bernie Marcus announced that he would retire as the head of the company that he had cofounded, ending a successful twenty-one-year tenure. The assumption had always been that Arthur Blank, the other cofounder, would succeed Marcus as CEO. However, due to a unique set of circumstances, The Home Depot board was presented with what they saw as a great opportunity to select a new high-profile leader from outside the company. As it turned out, this “opportunity” to bring in a CEO from outside the company did not live up to the board's expectations.

Home Depot's leadership transition just happened to coincide with the announcement by General Electric (GE) that Jack Welch, perhaps one of the most famous CEOs in the world, was also retiring. Three high-level executives at GE were waiting in the wings; all were hoping to be chosen for the position of CEO by GE's board. The candidates included Bob Nardelli, Jim McNerney, and Jeff Immelt. Eventually, the board chose Jeff Immelt to replace Welch; that left two other candidates, McNerney and Nardelli, free to make other career plans. McNerney moved on to become CEO of 3M Company and then eventually took the top leadership position at Boeing, the Seattle-based aircraft manufacturer. Bob Nardelli accepted Home Depot's offer to replace the retiring Marcus.

Poor Choices by Chairman

Unfortunately, as good as his credentials and his potential for success were, Nardelli's selection proved to be a poor choice. First, the new leader was given a controversial set of guaranteed bonuses and other out-of-market compensation options that never sat well with the company's investors and shareholders. Nardelli was also given a powerful title: Chairman, President, and CEO of The Home Depot. The compensation package and inherent power vested in Nardelli's titles soon resulted in a considerable downward trend for the company.

A Change of Direction

Instead of continuing the company's customer-driven focus that had kept

Home Depot's DYI customers loyal over the years, Nardelli chose a strategy that was focused on building market dominance in the wholesale building supply business. Nardelli initiated a series of large acquisitions, in this field aggressively acquiring an number of firms in this market. These acquisitions added significant debt to the balance sheet at a time when stiff competition, particularly from Lowe's, was chipping away at Home Depot's market advantage.

In addition, Nardelli's numbers-driven approach and confrontational, disruptive management style did not wear well with Home Depot's employees. Soon, these internal cultural problems trickled down to the customer level and ultimately showed up on the company's balance sheet as declining sales performance.

Share Price Drop

The Home Depot's stock price also reflected the impact of Nardelli's decisions. When Nardelli took over as CEO, the stock share price was $48.20 (January 2, 2001); when Nardelli departed the company in June of 2007, the stock price was $39.21. When this fall in share value is placed against the backdrop of a Dow Jones Industrial Average that grew from 10,887 to 13,688 during Nardelli's tenure, this indeed is a poor performance record. The continuation of Nardelli's extraordinarily generous compensation package just further angered the company's investors and shareholders.

In May of 2006, Nardelli made a huge tone-deaf decision in spite of the windstorm of investor and press criticism that was swirling around him at the time. Inexplicably, he moved the annual shareholder meeting from its home base in Georgia to the state of Delaware. Then, as if he were trying to add insult to injury, he requested that the company's board of directors not attend the meeting. This singularly poor example of board governance had very predictable results inside and outside the boardroom.

CNN Money.com put the controversy front and center in a May 26, 2006 article under the headline, “Shareholders to Home Depot Chief: You're Chicken.” The headline referred to an angry shareholder who got up at this relocated board meeting and told Nardelli point-blank, “You hide behind the various metrics, you won't report same store sales, you're chicken.” The board also got its share of vitriol from this unhappy shareholder. “This is outrageous that they (the board) are not willing to appear before shareholders," the shareholder said; " . . . I think they're too chicken to face shareholders, whether to allow a vote on CEO compensation or answer questions about the performance of the company."[2]

The denouement to this story was not long in coming. In February of 2007, Relational Investors, one of Home Depot's most significant investors, reached an agreement with the board to finally take decisive action. On February 22, 2007, David Batchelder, the founder of Relational Investors, joined the board. Four months later, in June of 2007, the company announced Nardelli's departure. In 2008 four of the then current directors involved in the original hiring of Nardelli were asked to leave the board.

Two Key Guiding Principles

The rise and fall of Bob Nardelli is on one hand a cautionary tale for boards, because it highlights the risks of going outside the company to hire the next CEO. The Nardelli story also illustrates two critical governance principles that will be covered in this chapter.

- The board cannot run the company, even if it desires to do so. The board's principle responsibility is to ensure that the right CEO is in place. Regardless of the size of the company, the wrong CEO, in the wrong place and at the wrong time, can change the course of an enterprise in a very short period of time, as was illustrated by the Home Depot saga.
- On the other hand, Home Depot's leadership experience also illustrates what can happen when the board chooses the right CEO. After dismissing Nardelli, the board chose Frank Blake as Nardelli's successor. He was the former GE General Counsel whom Nardelli had brought with him to Home Depot. Although Blake had no experience in the retail environment, the new CEO thoughtfully and calmly settled the company. He returned the cultural climate to an even keel and again focused the company on customer service. Store results soon confirmed that Blake was on the right track as Home Depot returned to its focus on the DYI customer and service. Blake recently retired, receiving great accolades from inside and outside the company.

Why Boards Exist

In a March 2013 speech given during a Kellogg School of Management/Aspen Institute Business and Society Conference, Aspen Institute Chairman David Langstaff noted that “the role of the board is to ensure that purpose, vision and core values are in place, and thus to give the CEO and the executive team the time and space to act responsibly.” Langstaff went on to say that “boards must also help CEOs counter the short-term presence of the market, and ensure that companies do not make short-term accommodating decisions that are not in its long-term interest as responsible contributors to society.”[3]

In slightly less precise but clear terms, boards exist principally to watch over the fiduciary interests of a company's shareholders and other interested stakeholders. It's a responsibility that extends to the widest range of stakeholders, including individual stockholders and those who manage mutual funds and/or those who select stocks based on a company's performance. This second group includes fund managers for universities and other public entities, as well as unions and all other groups that tie current and future pension payouts to the financial strength of a company.

The view that boards do not operate as a homogenous voting block that is concerned only with share price was echoed in March 2015 in the Schumpeter weekly column of the *Economist*, titled “The Business of Business.”

> *For decades, conservatives and progressives have argued over whether the purpose of a company is to maximize shareholder value or pursue boards' social needs. . . . In practice, of course, shareholders are often not a homogeneous block with a collective interest: Traders who buy on the whiff of a bid may have a different perspective from investors who have held shares for decades. Open-endedness reflects the reality of corporate life. Far from being slaves to the share price as progressives imagine most companies are engaged in a constant process of negotiation between managers and investors over other strategy and time horizons.*[4]

Laurence D. Fink, Chairman and CEO of BlackRock, the largest manager of money in the world, echoed this point of view in a March 31, 2015 letter to five hundred of the largest companies in the United States: “It is critical, however, to understand that corporate leaders' duty of care and loyalty is not to every investor or trade who owns the companies' share at any moment in time, but to the company and its long-term owners.”[5]

Three Critical Questions That Boards Ask

Whether the board meets once a month or, more typically, four to five times a year, a board is never actively engaged with the daily operations of a company. That's why the catch phrase, “noses in, fingers out,” is such an appropriate rubric to explain the work of corporate boards. Boards have a clearly defined advisory role. It is the CEO (along with the CEO's management team) who ultimately must run the company responsibly. Still, boards play an essential role in helping a company's leadership achieve both the company's strategic goals and meeting shareholder expectations. In many ways the principal value that board members offer is their collective wisdom to help companies answer three critical questions:

1. Is the right CEO running the company? This is not a single event, but part of a continuous evaluation process.
2. Does the company have a robust succession process, and does the plan include the appointment of a strong short-term successor for the business?
3. Does the company have the right strategy? If so, is that strategy being implemented effectively?

Is the Right CEO Running the Company?

Boards play a vital role in choosing a leader who is able to influence others to follow. William Shakespeare tapped this essential leadership capacity in the play *Henry IV, Part I* when Glendower boasts, ”I can call spirits from the vasty deep,” to which Hotspur replies, ”Why so can I, or so any man, but will they come when you do call for them?”[6]

Of course, finding the illusory “right leader” is no easy task, even if a potential CEO meets every criterion for past financial performance and experience levels, and even if that individual's values and leadership style perfectly fit with the organization's culture. The fact is, even if the perfectly aligned CEO has been chosen, failure is still possible. It's a story as old as recorded history.

Greek historian Plutarch more than two thousand years ago found that the right person in the right place at the right time makes all the difference. The truth is simply this: some individuals just have a way of overcoming obstacles and difficulties that stymied their predecessors and can reach goals that previous leaders were unable to reach.

As the management consultant, educator, and author Peter F. Drucker once said,

> *An effective executive does not need to be a leader in the sense that is now most commonly used. Harry Truman did not have an ounce of charisma. Some of the best business and nonprofit CEOs I've worked with over a 65 year consulting career were not stereotypical leaders. They were all over the map in terms of their personalities, attributes, values, strengths, and weaknesses. They range from extroverted to nearly reclusive, from easy-going to controlling, from generous to parsimonious.*[7]

Predicting Leader Success Is Impossible

In the end the only way to tell if a right leadership choice has been made is to observe the job performance of the candidate. As Matthew J. Paese, vice president of executive solutions at Development Dimensions International (DDI), positioned this dilemma: “I am still waiting for the true realist to emerge from the board and announce, ‘We are making this CEO succession decision recognizing that it probably won't work out and that next year at this time we will be looking for a replacement.’”[8] Of course, it is absurd to imagine any board openly stating the expected failure of an incoming CEO, but from a purely statistical point of view, it's not an outrageous statement. In fact, over the last decade, CEO turnover has increased by more than 50 percent and performance-related departures have increased by more than 300 percent.

The Cost of a Wrong Choice

The price for failed leadership at the CEO level is almost incalculable, regardless of whether the candidate is internally developed or hired from the outside. The saga of Bob Nardelli's tenure as CEO of Home Depot is an instructive example. Another well-known example of the cost of hiring the wrong CEO is Hewlett-Packard's story of unfortunate leadership decisions that it made beginning in the late 1990s.

In David F. Larcker and Brian Tayan's 2011 article for the *Stanford Closer Look Series*, "Leadership Challenges at Hewlett-Packard (HP): Through the Looking Glass," the authors chronicle the story in detail, beginning with the hiring of Carly Fiorina, who was CEO between 1999 and 2005. After Fiorina's departure, the company cycled through four CEOs until 2011, including the current CEO Meg Whitman. Mark Hurd served as the HP leader between 2005 and 2010. Hurd's successor, Leo Apotheker, served only one year, from 2010 to 2011. Whitman, who had been serving as an independent member of the board before her tenure began in 2011, appears to be a good choice for the company, and in the last four years, she has brought the company much needed stability and a new strategic focus for the future.[9]

The Real HP Story

Still, beyond the disruption that this chaotic CEO turnover caused, the real story at HP was the consequence of a dysfunctional board making one bad CEO choice after another. CEO selection is difficult enough when a board is in full harmony and is constructively focused on effective succession; it's impossible when disarray prevails. So, what happened at this highly successful, global technology giant to prompt its board to make such highly destructive decisions?

A string of disappointing earnings reports ended Carly Fiorina's tenure. Mark Hurd was party to an embarrassing scandal that divided the board and prompted his dismissal after a six-to-four split vote. Leo Apotheker had a change of heart about selling HP's struggling PC division, and it was that flip-flop that resulted in a 20 percent drop in stock value; the board soon after showed Apotheker the door.

Larcker and Tayan's 2011 article drew the following very relevant conclusions about board governance:

- Two primary responsibilities of a board are the approval of corporate strategy and the selection of the CEO to refine and execute that strategy.
- The hallmark of a well-governed company is a reliable system for the development of internal managerial talent.[10]

Clearly, these governance priorities eluded the HP board during the tenures of Fiorina, Hurd, and Apotheker. It should be noted, however, that even if a critical decision is made by a group of highly experienced people, it is still entirely possible to get it dead wrong instead of “right.” This reality does not, of course, absolve any board from responsibility for the choices that it makes and the need for effective board governance practices.

As Eric Jackson noted in his 2012 *Forbes* blog criticizing the HP board, “It's difficult enough to find the best CEO when going outside the organization, but if the board does not have its act together it is nearly impossible for a board to be effective.”[11]

How to Make the Right Choice

How can boards ensure that they've made the best possible leadership choice throughout a CEO's tenure? As we've noted elsewhere in this book, CEO assessment is not a single event but, rather, a continuous process of evaluation that takes place during every interaction that a board has with a company's CEO. This interaction includes both principle (such as board meetings) and secondary (quarterly earnings calls) opportunities that help board members assess a CEO's performance.

- **Board Meetings:** Board meetings are a perfect opportunity for members to observe how the CEO interacts with other senior team members as they answer questions or lead discussions. Sometimes meetings are held away from the boardroom (perhaps annually or biannually) to conduct in-depth strategy reviews or to visit company facilities. These meetings present another good opportunity for board members to interact with the CEO's team and other key member of management, including possible successors to the CEO.
- **Direct Board and CEO Meetings:** Regularly scheduled sessions with the board and the CEO, without any other members of management being present, offers a good opportunity for open dialogue on any issue, including long-term and short-term succession plans, problems with direct reports, and strategic issues. These meetings and conversations are also an excellent way for the board to gain an understanding of how the CEO approaches and solves challenges. Some boards hold these sessions during dinner or perhaps during breakfast. But, no matter when they are scheduled, such meetings engender a very open and forthright relationship, and such open dialogue should be scheduled during every board meeting. With rare exceptions, this forum is appropriate for discussion of almost any topic.
- **Annual Assessments:** An annual assessment yields very specific information about a CEO's performance. Any observations or recommendations that emerge from this assessment should be communicated to the CEO by at least two board members, including the lead director or a proxy and, depending the board's structure, the chair of the Compensation Committee or the chair of the Governance/Nominating

Committee.

- **Executive Sessions of the Board:** An executive session is a meeting for independent directors alone, without the CEO. During these discussions, the role of the lead director is critical to ensure a constructive discussion that addresses the individual or collective concerns of the board. This meeting is critical to the building of confidence within the board that the board has chosen the right CEO.
- **Quarterly Earnings Calls:** A quarterly earnings call represents an excellent opportunity for board members to observe how the CEO and the CEO's team present the results and handle the analyst's questions. Members should pay close attention to those questions, since they offer a window into how the market is viewing the company's challenges and execution. Note that not every CEO is comfortable handling these important calls, so this job is sometimes deferred to the chief financial officer (CFO).

Is a Robust Succession Plan in Place?

The full board, not a committee, is responsible for agreeing on who the short-term emergency successor should be if something happens to the CEO. A good practice is to develop a formal emergency plan that outlines in detail who should be contacted and in what order if such an unexpected event takes place.

One of the best ways to ensure that a robust succession plan is in place is to establish the practice of conducting an annual review of the company's succession and management development plans.

The board also has the responsibility of ensuring that the right future leaders of the business are being developed. Ideally, this detailed succession plan is an annual presentation to the board that is also part of a robust, active human resource development plan. Generally, these individuals report directly to the CEO and often are considered a potential successor to the chief executive; other candidates below this reporting level are considered as high-potential candidates for leadership. In addition, the board must be comfortable with the difficult job of discussing performance issues with the CEO.

Regardless of whether the choice of successor is a member of the board or a senior officer not yet considered to be the long-term candidate for CEO successor, it is essential that a board reach a consensus on this critical matter. What the board must avoid is making this decision in an emergency situation. The days are long past when a board accepts that the Chairman/CEO's succession directive is contained in an envelope that is kept in a middle desk drawer.

Determining the Right Strategy

While it's true that the board does not run the organization, board members still expect the CEO and the CEO's management team to present an effective strategic plan and to execute it effectively. Regardless of the procedural matters that occupy the board's time and attention, the most effective boards find ways to devote sufficient time to this critical subject. It is not an unreasonable request to add an extra day to a board's schedule each year to review the strategic plan and to fully reflect on both the soundness of the strategic plan and the risks in its execution. Quite often speakers such as investment bankers or consultants from outside the company are included in these meetings, because they can provide insight on particular issues. Here are some other activities that contribute to determining the right strategy:

- **Regularly Scheduled Meetings:** One of the biggest benefits of the regularly scheduled informal meeting between just the CEO and the board of directors is the opportunity for directors to ask questions or to raise doubts about strategic matters in a more open, informal setting without other members of the management team being present.
- **Communication between Scheduled Meetings:** Boards keep attuned to strategic issues and also determine strategy by means of regular communication with the CEO, such as monthly reports about the company that includes analysts' reports or copies of presentations to the investment community.
- **Materials for Board Meeting:** It's important to include materials in board meetings that provide information that is more than an assessment of stock prices and financial data or information about the company's competitors. Understanding and following what is taking place in the competitive marketplace is an important component of tracking the efficacy of the company's strategy. Sometimes apparent strong performance is a consequence of strong industry fundamentals or perhaps even weak fundamentals. Sometimes the company's performance is not as strong as the numbers suggest, and at other times the weak financials do not present a true picture of underlying strength. Boards must make these determinations and judge if the company's strategy is flawed or perhaps lacking in execution. It is no easy job to wade through these many

sources of information in order to address fundamental operational questions.

Chapter Summary

A corporate board has two main duties to fulfill:

1. Ensure that the right CEO is in place.
2. Watch over the fiduciary interests of the company, shareholders, investors, and all other stakeholders who are impacted by the decisions made by the board.

In addition, there are three key questions that must always be front and center in the minds of all board members:

1. Is the right CEO running the company?
2. Is the company following the right strategy?
3. Is a robust succession plan in place?

Choosing the wrong CEO can be very costly, as the saga of Home Depot's high-profile CEO clearly illustrates. To avoid this mistake, Chapter 3, “Key Board Leadership Roles,” offers some effective ways for board members to monitor the CEO's impact on the company and the CEO's fit with the company's cultural and organizational values. These techniques include simple observations at regular board meetings; conducting one-on-one meetings with the board and CEO without other members of management being present; and observations and interactions during annual assessments, executive board sessions, and quarterly earnings calls.

Boards must also ensure that they have enough information to allow them to determine whether the company is following the right strategy. A number of techniques were offered in this chapter, including adding additional time to a board's schedule to review strategic plans and potential risks to the strategy, one-on-one meetings between the CEO and directors, regular reports from the CEO that include analysts' reports about the company, and copies of the CEO's presentations to the investment community. Boards should also insist that complete board briefing materials be provided so that members can independently assess important strategic and operational questions.

Finally, it is the board's responsibility to ensure that both a long-term and a short-term succession plan is always in place.

What's Next?

Corporate boards and their internal governing policies and procedures are directly influenced by both the societal concerns of the moment and the overall vibrancy of the economic landscape. Since every board is unique, each will respond to the same set of external conditions in a way that suits its individual circumstances and culture. Chapter 3, “Key Board Leadership Roles,” explores some of the most significant economic and cultural shifts that have occurred over the last twenty years and examines how they have impacted the way boards operate and, ultimately, the decisions that every board makes.

Notes

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[3] David H. Langstaff, "Rethinking Shareholder Value and the Purpose of the Corporation" (speech presented at the Kellogg School of Management–Northwestern University Aspen Institute Business and Society Program, March 7–8, 2013).

[4] Schumpeter, "The Business of Business," An Old Debate about What Companies Are for Has Been Revived, *Economist*, March 21, 2015. Accessed July 31, 2015, www.economist.com/news/business/21646742-old-debate-about-what-companies-are-has-been-revived-business-business.

[5] Letter by Laurence D. Fink, Chairman and CEO of BlackRock, to five hundred companies in the United States, March 31, 2015.

[6] William Shakespeare, *Henry IV, Part I*, Act 3, Scene 1, 52–58.

[7] Peter F. Drucker, "What Makes an Effective Manager," *Harvard Business Review*, June 2004, 59.

[8] Matthew J. Paese, "Your Next CEO: Why Succession Planning Is More Important Than Ever," *Conference Board Review*, October 11, 2001, 19.

[9] David F. Larcker and Brian Tayan, "Leadership Challenges at Hewlett-Packard: Through the Looking Glass," S*tanford Closer Look Series*, 2011.

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[11] Eric Jackson, "Six Years Later—The Problem at HP Is Still the Board," *Forbes* (blog), January 16, 2012. Accessed August 1, 2015, www.forbes.com/sites/ericjackson/2012/01/16/six-years-later-the-

problem-at-hp-is-still-the-board.

CHAPTER 3
KEY BOARD LEADERSHIP ROLES

What's in This Chapter?

- Why Leadership Roles Have Changed
- The Debate about Role Separation
- Nonexecutive Chairman/Lead or Presiding Director
- The Challenge of Board Leadership
- Chapter Summary and What's Next

Corporate boards and their internal governing policies and procedures are directly influenced by the societal concerns of the moment and the overall vibrancy of the business environment and economy. As we noted in Chapter 1, "The Changing World of Board Governance: How We Got Here," each board is unique and responds to challenges in ways that suit its individual circumstances and culture. This chapter explores how some of the most game-changing social and economic challenges faced by boards over the last twenty years have altered both governance policies and practices, and, importantly, how CEOs interact with their boards.

As discussed briefly in Chapter 1, the 1990s was an era of economic expansion. Then Secretary of the Treasury Alan Greenspan even characterized those years as a time of "irrational exuberance" in a 1996 speech given at The American Enterprise Institute for Public Policy Research.[1]

The Dow Jones Industrial Average began the decade at 2,563 and climbed year after year during what became known as the dot.com bubble until it reached 11,501 at the end of the cycle. When the bubble burst, the economic fallout across the board was swift and painful for individual and institutional investors who lost billions of dollars, while thousands of employees were left unemployed when the dust settled.

Perhaps the most recognizable examples of Greenspan's "exuberance" was Ken Lay, CEO of Enron, who was praised by every business publication and media outlet as innovative and a shining example of a "new economy maverick."[2] Clearly, such high-flying, profit-taking executives as Lay were very much idolized and apparently could do no wrong. That opinion changed overnight as Enron (and other poster companies for excess, notably WorldCom and Tyco) were revealed as the chief purveyors of corporate malefeasance.

The Demise of WorldCom

WorldCom Files for Bankruptcy—Largest U.S. Case

WorldCom, plagued by the rapid erosion of its profits and an accounting scandal that created billions in illusory earnings, last night submitted the largest bankruptcy filing in United States history.

The bankruptcy is expected to shake an already wobbling telecommunications industry, but is unlikely to have an immediate impact on customers, including the 20 million users of its MCI long-distance service.

The WorldCom filing listed more than $107 billion in assets, far surpassing those of Enron, which filed for bankruptcy last December. The WorldCom filing had been anticipated since the company disclosed in late June that it had improperly accounted for more than $3.8 billion of expenses.[3]

Public Outcry for Action

The result of these revelations was a public outcry for action, and overnight the public sentiment changed from an attitude that business "could do no wrong" to one of "business could do nothing right." Congress and federal regulators responded by passing the Sarbanes-Oxley Act (SOX) in July 2002, while at the behest of the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), also in July 2002, implemented new and dramatically changed governance requirements in their Listed Company Manual.

Both actions represented a dramatic change in the world of corporate governance. SOX, as passed by Congress, was focused primarily on protecting investors from fraudulent accounting practices, as exemplified by the egregious practices that had taken place at Enron and WorldCom.

Specifically, the provisions in SOX were aimed at ensuring the integrity of financial statements of publicly traded companies. It made the following changes to the internal accounting controls.

- **Public and Independent Oversight of Company Audits:** As an outcome of the Enron collapse, the Chicago-based public accounting firm Arthur Anderson, LLP was found criminally liable and was forced into bankruptcy. As part of SOX, the Public Company Accounting Oversight Board (PCAOB) was created, as their website describes: "The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[4]
- A requirement was included to actively improve auditing and corporate governance practices by further defining the independence of the audit committee, requiring the designation of a committee "financial expert" and the committee and board determination of the audit committee members as financially qualified. Further, the committee was given the sole responsibility for hiring the public accounting firm, including the requirement that the firm report directly to the audit committee.
- More accountability and transparency focused on investor protection,

including, among other things, the written certification by the chief executive officer (CEO) and chief financial officer (CFO) of the integrity of the quarterly and annual financial reports and statements.

- More independence for auditors and the services that they provide, along with a requirement to rotate audit partners every five years.

Obviously, these were enormous changes for the audit committee and the board. These important changes, with modifications and improvements along the way, as implemented by the PCAOB, continue to this day.

Changes in Nyse Listing Requirements

As noted, coincidental to the passage of the Sarbanes-Oxley Act, the implantation of the new NYSE governance requirements brought far-reaching changes to board governance practices. In fact, as significant as SOX was to the audit committee and management, the new NYSE governance guidelines dramatically altered the governance landscape for directors, the board, and the investor community. The revised Section 303A of the NYSE Listed Company Manual included the following game-changing clauses:

- The board of directors of a publicly listed and traded company must be composed of a majority of independent directors.
- The determination of independence of a director must be affirmed by the board, including no material relationship with the listed company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company, including such current employees as the CEO or CFO.
- Listed companies must have a nominating/governance committee, audit committee, and compensation committee composed entirely of independent directors. Other committees are permitted, but these three are required. In the early days following the passage of the regulations, many CEOs had a difficult time understanding that they could no longer vote as a member of these standing committees.
- An annual performance evaluation of each of the three required standing committees must be conducted.
- The board should conduct a self-evaluation at least annually to determine whether it and its committee are functioning effectively.
- Corporate governance guidelines must address director orientation and continuing education, along with policies limiting the number of boards on which a director may sit and director tenure, retirement, and succession. Finally, the guidelines must outline investor access to management and, as necessary and appropriate, the right to obtain independent advisors.

As significant as these changes were, one section (303A.03 Executive

Session) changed the very nature of the relationship between CEOs and their board directors. As stated in the NYSE Listed Company Manual,

> *To empower non-management directors to serve as a more effective check on management, the nonmanagement director of each listed company must meet at regularly scheduled executive sessions without management.*

The Debate Over the Separation of Roles

Prior to the events of 2001, the question of separation of the roles of chairman and CEO was not at issue. Since that time the issue of whether or not to allow a dual role of Chairman/CEO has become a very contentious one.

For many shareholder groups, particularly the ones that are more activist, there is no question that the two roles should be separate. These activist groups cite the European model, in which a traditionally very strong executive chairman is also a member of management, along with the CEO. Great significance is placed not only on the CEO but also on the executive chairman. Usually, extensive press coverage is focused on both positons.

This arrangement is not always successful, as the recent upheaval at Volkswagen demonstrates. Chairman Fernando Piech, a member of Volkswagen's founding family, endeavored to marshal shareholder support for the removal of the CEO.

The news service Reuters reported on the power struggle on April 15, 2015, under the headline “VW struggles in ‘Diplomacy Phase’ as Investors Weigh CEO Change.” Eventually, Chairman Piech lost his bid to get the support of another family member and significant shareholder, Wolfgang Porsche, and Piech subsequently resigned.[5]

An example in the United States is the debate over whether Robert Iger, currently CEO of Disney, should assume the title of chairman. To put the issue in context, his predecessor, Michael Eisner, was stripped of the title over several very contentious issues with shareholders. When Eisner was finally forced to leave office and Iger became Disney's CEO, the job title did not include that of chairman. However, after a number of years of very strong performance, the board decided to give Iger the dual title of Chairman/CEO.

The Connecticut Retirement Plan and Trust Fund (CRPTF) objected to Iger's receiving the title of chairman in a proxy proposal: “We believe that the role of the Chief Executive Officer and management is to run the business of the company and the role of the board is to oversee management. We believe given these different roles and responsibilities, leadership of the board should be separate from leadership of management.”[6]

Large Financial Institution Example

After J.P. Morgan experienced significant losses in their U.K. operations—known as the “London Whale” episode, when a single employee lost billions of dollars on risky trades—activist shareholder groups placed a proxy demand for the separation of the chairmanship from CEO for Jamie Dimon. After a lengthy period of public debate, the company prevailed and Jamie Dimon retained his title as Chairman/CEO; as part of the debate, J.P. Morgan did institute the position of a strengthened lead director.

According to Spencer Stuart's 2014 Board Index report, 53 percent of the S&P 500 companies currently combine the titles of chairman and CEO versus 74 percent in 2004.[7] Some of that change in separation of roles is due to the continuation of historical practices, while others are part of a CEO succession practice. In those cases the current Chairman/CEO gives up the title of CEO, retaining the title of executive chairman in order to facilitate an effective transition in responsibilities. When the executive chairman retires, the CEO normally assumes the title of chairman.

Should CEO and Director be Separate Roles?

Is it better to separate the role of chairman from that of CEO? Does the separation really enhance board governance and effectiveness?

The answer to these questions may lie in a lack of understanding of how boards function. Do some Chairman/CEOs or CEOs try to control and manage their boards and refuse to share important information? The short answer is “yes,” but they are the rare exception. However, whether the CEO is chairman of the board or not, today boards are much more involved and engaged in the board's agenda, committee functions, and operations, and in assuring that the board's responsibilities and fiduciary duties are satisfactorily fulfilled. As noted earlier, the world of board governance changed when the independent directors were required by the new NYSE Listed Company Manual rules to meet alone periodically, without the CEO being present. This requirement allows the independent director to address any and all concerns that he or she may have about the CEO and the CEO's team and strategy, or any other critical issue, including succession planning.

As noted by David F. Larcker and Brian Tayan in the March 14, 2013 *Stanford Closer Look Series* article, “Where Experts Get It Wrong: Independence vs. Leadership in Corporate Governance”: “Independence, as beneficial as it may sound, may have less value than we all assume. Many observed structured features of corporate governance have little or no relation to governance qualities. For example, there is little systematic evidence that it benefits a company to have an independent chairman.”[8]

Along with arguments on both sides, the largest manager of securities is now weighing in. BlackRock, the largest of such companies, has provided the following statement in their “Proxy Voting Guidelines for U.S. Securities,” dated February 2015.

> *We believe that independent leadership is important in the board room. In the U.S. there are two commonly accepted structures for independent board leadership: 1) an independent chairman; and 2) a lead independent director. We assess the experience and governance track record of the independent chairman or lead director to understand capability and suitability to effectively and constructively lead a board. Our expectations of an individual in this role include, but are not limited to: being available to serve as an advisor to the CEO, contributing to the oversight of CEO and management succession planning, and being available to meet with shareholders when they have highly sensitive concerns about management or corporate governance issues. We generally consider the designation of a lead independent director as an acceptable alternative to an independent chair, has a term of at least one year and has powers to: 1) provide formal input into board agendas; 2) call meetings of the independent directors; and 3) preside at meetings of the independent directors. Where a company does not have a lead independent director that meets these criteria, we generally support the separation of chairman and CEO.*[9]

Nonexecutive Chairman, Lead Director, or Presiding Director

The board leadership positions of nonexecutive chairman, lead director, or presiding director have become very important since 2002. A vast majority (90 percent) of S&P 500 companies have either a lead director or a presiding director, while a smaller percentage (28 percent) have an independent chairman.[10] Nevertheless, the switch from familiar meeting protocols that were in place before 2002 has meant re-evaluating fundamental governance practices, including the frequency of the meetings held without the CEO being present, leadership of the discussions during these sessions (the general practice today is that the lead director is in charge of these discussions), and how to best communicate the results of these independent meetings to the larger board.

Defining the Role of Nonexecutive Chairman

The nonexecutive chairman is responsible for calling the board meeting to order and, as appropriate, taking charge of moving the proceedings along. Once the meeting is officially open, normally the nonexecutive chairman turns the meeting over to the CEO, who directs any activities necessary to complete the board's agenda.

During an annual meeting, the nonexecutive chairman usually calls the meeting to order by reading a prepared script in order to ensure that any proxy protocol is followed. The CEO leads the business discussions and answers any relevant questions, unless other members of the board are asked to provide input. This is a brief overview, but perhaps a bit of personal experience might add some value.

About fifteen years ago, I served as the nonexecutive chairman of Nucor, the largest steel producer in the United States, based in Charlotte, North Carolina. At the time the board had just voted to elect Dan DiMicco as its next CEO, so the directors decided that my experience as both a board member and a former CEO would help Dan settle into his new role. As a result I remained the nonexecutive chairman until 2006, when the board decided to acknowledge Dan's well-recognized success by electing him as both chairman and CEO (Dan's record included a significant increase in the stock price). When Dan took over as chairman, I had no duties beyond the nonexecutive chair responsibilities that I noted earlier.

So, what do these three board leadership roles—nonexecutive chairman, lead director, and presiding director—have in common? In the simplest of terms, they act as the honest broker between the CEO and the board, and vice versa. When the executive sessions occur, the lead director has the responsibility of meeting with the CEO to provide direct feedback from the board. These one-on-one feedback sessions usually occur immediately after the independent board meetings. However, it is sometimes constructive to ask the CEO to join the session at the end of discussion so that the CEO can clearly understand the sentiment and suggestions of the independent board.

The Challenge of Board Leadership

Leading an effective executive session is an art that allows all points of view and concerns to be heard without allowing the session to become unnecessarily protracted and unproductive. Knowing when to allow further deliberation or when to move on takes skill.

A good practice—and really a necessary one—is for the lead director to meet in person, or communicate with, the CEO between meetings. The purpose might be to discuss the agenda or the schedule for the next meeting, or the discussion might revolve around how to engage the board between meetings on a pending acquisition, merger, divestiture, or other key strategic move. How often, where, and how these meetings should take place is determined by the physical location of the CEO and the lead director. Sometimes it is convenient to schedule a face-to-face meeting, whereas at other times connecting by phone between meetings makes more sense.

Challenges of Transition and Letting Go

The lead director plays a critical role before, during, and after a CEO transition. For example, a lead director helps ensure that the timing of the transition is right and that questions about board membership status are answered. In many ways the lead director often acts as the honest broker between the incumbent CEO and the board by ensuring that all voices are heard, that mutual concerns are addressed, and that an effective transition is facilitated.

Letting Go of Leadership

Being an “honest broker” is especially important if the incumbent Chairman/CEO or CEO is having difficulty letting go of his or her leadership position. Certainly, the board should be engaged in the process of CEO transition, but the lead director plays the most critical role in assuring a successful and smooth transition. The lead director also plays a key role if the board decides that the current Chairman/CEO should step down and assume a position of executive chairman in order to allow new leadership to transition in. A recent example of this strategy occurred recently when Cisco's long-time chairman, John Chambers, announced that he would step down as CEO and take a position as executive chairman. As reported in the May 4, 2015 edition of the *New York Times*, Chambers stepped down to allow a younger, new generation of leadership to succeed him.[11]

In these circumstances the lead director plays a critical role, interacting with both the incumbent and the board in order to ensure a successful transition and to determine the duties and responsibilities of the executive chairman, including how the former CEO will spend his or her time during the transition and when the CEO will officially leave the board.

Communicating with Shareholders

Lead directors are also playing an increasingly important role in communicating with shareholders on behalf of the board and the company. Sometimes the lead director is accompanied by the CEO, and at other times, with fellow directors or sometimes alone. Until recently, such direct communication has been an exception. You can easily find governance guidelines concerning such communication on the websites of many companies. Here is an example from Lowe's “Governance Guidelines”:

Board Interaction with Institutional Investors, Media, and Customers

> *“The board believes that the management and specifically the Chief Executive Officer or his designee, speak for Lowe's and in Nucor Corporation governance guidelines.”*[12]

And here's an example from Nucor's “Governance Principles”:

Communication with Third Parties

> *“Management and, specifically, the CEO and his or her designee, speak for Nucor Corporation. It is expected that directors would not speak for the company except in unusual circumstances.”*[13]

Institutional Investor Activity

In my role as lead director for one company, I met with shareholders both alone and with fellow directors and the company CEO. Since the meetings took place prior to a potential proxy fight, I also met with Institutional Shareholder Services (ISS) to explain my company's side of the argument.

Large institutional shareholders such as BlackRock, Vanguard, and others now take a public stance on certain governance matters or regarding a specific position on a company's proxy vote.

The CEO of Vanguard, William NcNabb, went to great lengths in a February 2015 letter to large corporations to explain why an ongoing dialogue between the company and Vanguard was not only invited but also expected: “The relationship between the corporate boards and large shareholders is important, but too often, there is precious little communication between the two parties. The case for effective engagement is compelling for both shareholders and boards.”[14]

Larry Fink, chairman and CEO of BlackRock, echoed this sentiment in a letter to corporations dated March 3, 2015: “Asset managers like BlackRock also have an important role to play, which is why we engage actively with companies on the key governance factors that in our experience support long-term, sustainable, financial performance.”[15]

In the future expect more calls for communication between the board and major shareholders, and an increasing responsibility for the lead director to be an “honest broker.”

Chapter Summary

In this chapter we explored how some of the most game-changing social and economic events of the last twenty years have reshaped governance policy and practices as well as the relationship between CEOs and their boards.

Specifically, the demise of Enron, WorldCom, and Tyco in 2002 were offered as the capstone event to a long period of corporate excess that began in the 1990s. The corporate malfeasance that was exposed when these companies filed for bankruptcy prompted a series of legislative and regulatory actions in 2002 that included passage of the Sarbanes-Oxley Act, significant changes to the NYSE Listed Company Manual, and new SEC regulatory requirements.

This chapter used these major upheavals in the marketplace and the impact on corporate board governance as the background for a thorough discussion of board leadership roles—specifically, the efficacy of allowing a CEO to also serve as board chairman.

In addition, this chapter provided a substantial discussion of the nonexecutive chairman's role (also called the lead director or presiding director). Most companies have either a lead director or a presiding director, whereas about one-third have an independent chairman.

Finally, the chapter offers a set of useful guidelines for effective board leadership, along with useful tips on effectively communicating with shareholders.

What's Next?

As the world of board governance continues to change, activist groups of shareholders approach companies with various proposals, ongoing requests are made for a split of the Chairman/CEO roles, proxy access is either in place or about to be voted on in the next proxy, and there is continuing pressure to have a satisfactory advisory vote on pay, the importance of the role of lead director will continue if not increase. As contentious and important issues are brought before the board and shareholders for votes, the need for the lead director to facilitate open and constructive dialogue between independent directors and the CEO of the company will be more important than ever.

As for the debate over the separation of roles, it will continue to be found on the front pages of the business press. Every time an activist shareholder group feels as if the company is not performing and/or accuses the company of possible wrongdoing, the proxy for the next annual meeting is likely to include a request for the separation of the roles of chairman and CEO. The response is also likely to be that separation of the roles is not necessary as the board embraces the role of the “strong lead director,” including the right to call a meeting of the board, direct involvement in the setting of the agenda of the board meetings, and so forth.

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[15] Letter by Larry Fink, Chairman and CEO of BlackRock, to corporations, March 3, 2015.

CHAPTER 4
BOARD CULTURE

What's in This Chapter?

- Understanding Board Culture
- The Three Elements of Board Culture
- The Leadership and Board Performance Cycle
- Transforming Board Culture
- Chapter Summary and What's Next

Corporate boards, like any other gathered group of business or community leaders, are organized with two key outcomes in mind: to make good decisions and to identify emerging opportunities that will add value to their organization. Unfortunately, this seemingly crystal clear mission and the logical results that one might expect to emerge from such gatherings are often muddled by a whole range of group dynamics and human factors that seriously impact effectiveness and performance. This chapter examines why these human factors frequently derail the efforts of even the best corporate boards and provides research-based techniques that ensure mistakes that stand in the way of corporate boards attempting to accomplish their vital governance role are avoided.

Understanding Board Culture

The term *culture* was first used by researcher Elliott Jaques in 1951 to describe the unique climate or personality of an organization, or, as Jaques characterized it at the time, "the way things get done around here."[1] We define *board culture* a little more precisely. For us, board culture is *the unique, shared mind-set of a group of directors that dictates norms of engagement, communication, conflict management, and problem-solving processes.*

Researchers such as Edgar H. Schein have refined this description of organizational culture. His 1985 seminal work on this topic identified four distinct seen and unseen layers of culture that Schein labeled as

1. Patterns of Behavior
2. Norms
3. Values
4. Basic Assumptions[2]

Patterns of Behavior: The patterns of communication, decision making, and conflict management practices are often referred to as "the way we do things around here." This observable aspect of board culture also dictates dress code and the degree of formality.

Norms: Just below the surface of visibility are norms, which are the "unwritten rules" of engagement and represent what is expected, rewarded, and punished within the board.

Values: Values exist at a deeper level and reflect the underlying beliefs and values of the organization as a whole. While norms directly dictate acceptable and unacceptable behaviors, values are more deeply embedded and only indirectly influence behaviors.

Basic Assumptions: At the deepest level of culture are the basic assumptions of the board, which represent the tacit, "as-if" assumptions of the group and are often unspoken; in many instances, the board is not consciously aware of them. Primal issues such as abundance, scarcity, safety, and fear are grounded in this deepest level of culture.

A Brief Review of Board Culture Research

A pivotal and defining moment in board research occurred in the late 1990s when Daniel F. Forbes and Francis J. Milliken found that "intervening processes," or *group dynamics*, create unique cultures that impact board discussion and dialogue, and, ultimately, variances in corporate performance.[3]

Prior to this seminal work, research on board governance focused on structure, rules, procedures, and committee responsibilities. Ongoing research has consistently demonstrated the importance of board culture and interpersonal dynamics on board decision making, problem solving, and overall performance.

Jeffrey A. Sonnenfeld argued in 2002 that what separates exemplary boards from average or below-average boards is *social* and not structural, stating that boards are living social systems and that high-performing boards are grounded in the "virtuous cycle" of respect, trust, and candor.[4] Researchers Kathleen Eisenhardt, Jean Kahwajy, and L. J. Bourgeois in 1997 found that this shared respect and trust among board members allows even the most "sacred cow" discussions to occur without impacting the high-performing companies studied.[5]

More recently the *Director Notes* publication from The Conference Board (2014) suggests that the overall team dynamics created by the board culture is more important than the qualifications, skills, and experiences of individual directors.[6] In fact, this report suggests that board assessment should include a measure of the overall culture of the board as a whole, in addition to individual director peer-to-peer assessments.

Examples Illustrating Schein's Model of Culture and Board Dynamics

Since research-based conclusions are often best understood (despite their precision) by example, following are a few examples that explain how Schein's conclusions about cultural formation might be manifested in the real world.

A Nominally Engaged Board

Imagine a board whose members are only nominally engaged. Dissent and conflict are the norm within the group. Multiple agendas frequently circulate simultaneously, causing confusion. Open disagreements occur frequently among the board members, the CEO, and the senior management team. Moreover, the prevailing assumption among the board members is that the CEO and the senior management team have a hidden agenda, so nothing that leadership says is taken at face value.

How would you characterize this board's culture by applying Schein's four levels? Here is how we would analyze this board's culture:

> **Patterns of Behavior:** Disagreement, dissent, open conflict, and tardiness.
>
> **Norms:** Members are distracted and often challenge the CEO and the senior management team.
>
> **Values:** A “trust but verify” atmosphere underlies board interactions.
>
> **Basic Assumptions:** People cannot be trusted, and we live in a “zero-sum” world of scarcity.

A Highly Engaged Board

Now, imagine a board that is characterized by highly engaged directors. Robust and candid conversations occur often among the board members, the CEO, and the senior management team. The agenda is well understood and is universally shared. Directors are always prepared, and the group deftly balances candor and objectivity, leading to trust. The group is optimistic and excited about the future.

How would you characterize this board's culture by applying Schein's four levels? Given this second scenario, here's how we would characterize this board's culture:

> **Patterns of Behavior:** Engagement, candor, and respect for differing opinions.
>
> **Norms:** Engagement, punctuality, respectful listening, and questioning.
>
> **Values:** Trust of the CEO and other directors; open to innovation and change.
>
> **Basic Assumptions:** People are trustworthy, and we live in a world of generative abundance.

The Three Elements of Board Culture

The previous examples illustrate Schein's concepts but beg the question: what creates a “scarcity” mind-set and culture versus one of “abundance?” Schein's work illustrates an important distinction about the multidimensional nature of board culture: one level impacts another, and board culture is founded on basic assumptions. However, just because you understand the basic assumptions driving behaviors, this doesn't mean that this insight will ensure effectiveness, as illustrated later in this chapter when we introduce our model, *The Leadership and Board Performance Cycle* (see Figure 4.2). Before we discuss practical strategies for understanding and managing board culture, it is important to understand where and how board culture is developed and reinforced. Too often we want to blame the “leader” as the culprit behind a dysfunctional board. And, although the style of the CEO has a definite impact on board culture and performance, it is only one of several factors that impact that culture.

As illustrated above, board culture is complex, interrelated, and multifaceted. While there are numerous contextual aspects that are unique to each board, our experience suggests that board culture is created and sustained by three primary factors:

1. Individual personalities of board members.
2. Larger context or “macro-environment” factors impacting the business.
3. CEO leadership style.

Individual Personalities of Board Members

Although the overall group culture and dynamics of the board ultimately determine its effectiveness, individual personalities matter. In fact, they matter a lot. There is an old adage that one director cannot create a high-performing board, but one director can do a lot of damage.

Research using the “Big 5” personality model has been used to measure personality in an effort to predict leadership effectiveness. The “Big 5” personality model consists of five “Super Traits” that determine individual personality and style, as seen in Figure 4.1.

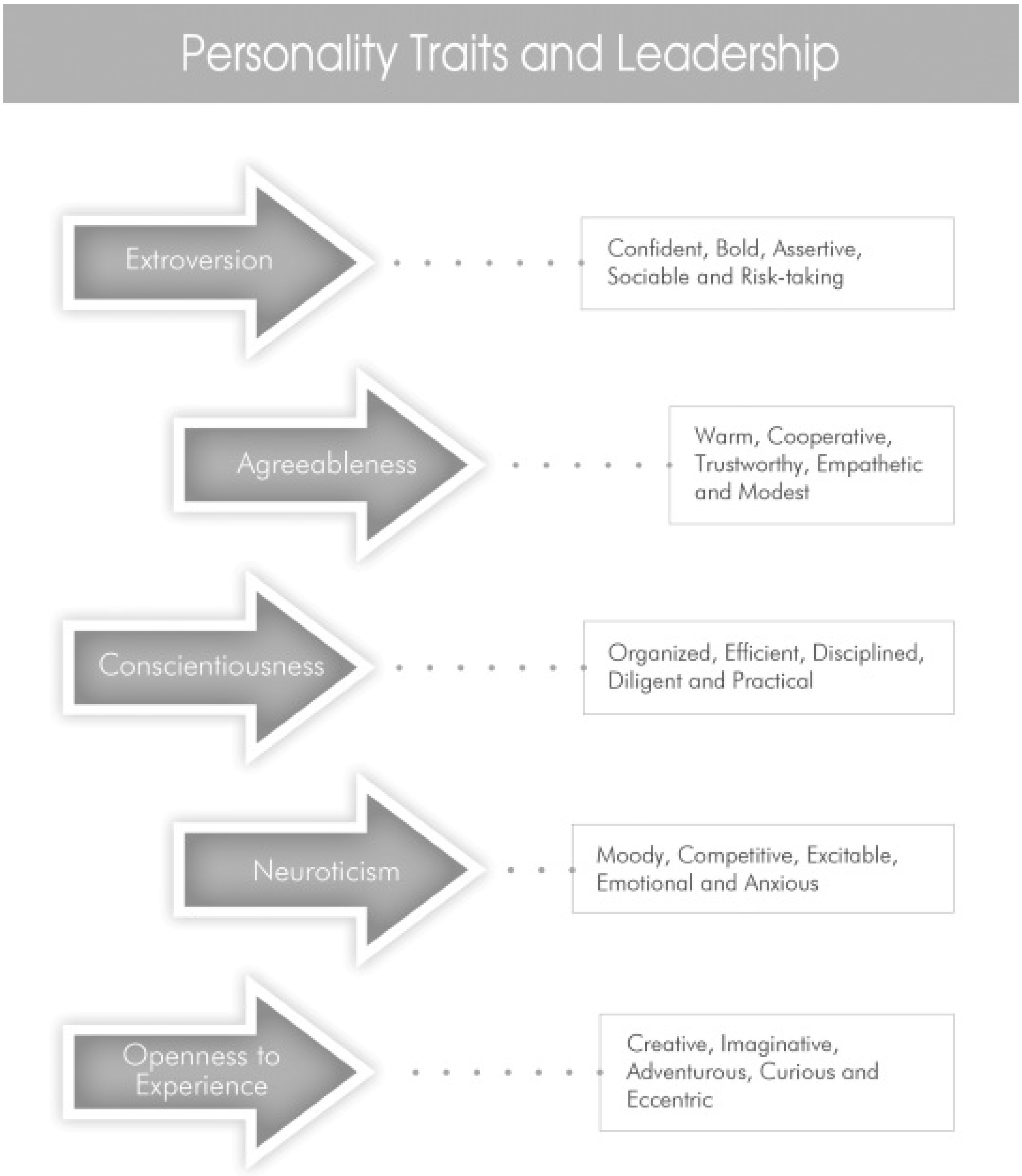
Personality Traits and Leadership
Extroversion
Confident, Bold, Assertive, Sociable and Risk-taking
Agreeableness
Warm, Cooperative, Trustworthy, Empathetic and Modest
Conscientiousness
Organized, Efficient, Disciplined, Diligent and Practical
Neuroticism
Moody, Competitive, Excitable, Emotional and Anxious
Openness to Experience
Creative, Imaginative, Adventurous, Curious and Eccentric

Figure 4.1 Personality Traits and Leadership

Although there is limited research that correlates the impact of personality with organizational success, there have been some studies conducted. For example, in 1999 Timothy Judge, Chad Higgins, Carl Thoresen, and Murray Barrick found that leaders who score higher in “Conscientiousness,” the trait of being organized, focused, and efficient, achieve greater levels of success. They may be extroverted and outspoken, or they may be introverted and more reserved. In either case, directors with this trait are more likely to be prepared for board meetings and to be more focused on performance.[7]

Another trait, “Neuroticism,” measures individual differences related to anxiety, anger, and impulsiveness. Leaders with higher scores for this trait are often correlated with being moody, temperamental, and envious. At their best, these directors can also be charming, charismatic, and self-confident, coming across as bold and visionary. Not surprisingly, however, this trait tends to predict lower levels of empathy and collaboration, as Michael Maccoby noted in 2004. Directors with this trait are likely to make favorable first impressions, but they can become frustrated and disruptive.[8]

Another example is the trait of “Agreeableness,” which is related to being trusting, modest, empathetic, and collaborative. Leaders who score high in this trait are dependable, effective listeners; are inclusive; and prefer to work together as a team to accomplish goals. With this approach, they are successful at producing long-term results.

The Larger Context or “Macro-Environment” Factors Impacting the Business

The second factor impacting board culture is the larger macro-environment, or context, in which the organization exists. For example, is the business growing and expanding, or is it contracting? Are technology and the global environment helping to drive innovation, or are they making the organization's products and services obsolete? In addition to these macro factors, contemporary issues such as shareholder activism and regulatory oversight impact board culture. For an example of how these issues impact board culture, let's examine shareholder activism.

Activist shareholders are more prevalent today than ever before. Many activist shareholders who take a significant position in a given stock are not necessarily seeking a seat on the board. Rather, they desire to have a direct line to the CEO and management team to express their concerns, provide advice, and influence the activities of the organization. Although this situation is undoubtedly more disruptive for the management team, it can and does impact the dynamics of the board and, as a result, the board culture.

On occasion, activist shareholders will demand a seat on the board, which leads to a much deeper level of engagement, not only with the management team, but also with the board itself. Often, at least at the outset, these shareholder board members are regarded skeptically by the other board members because they have come by their board seat in a coercive fashion. They often have goals that may be short term in nature and perhaps inconsistent with the longer-term vision held by the board. In the worst case, this type of scenario can be very disruptive to the culture and dynamics of the board by severely damaging open, honest dialogue in the boardroom and creating tension among board members on key strategic issues. In some cases this can lead to more hallway and off-line discussions between board members instead of a healthy debate around the boardroom table.

Longer-Term Strategy

In the best circumstances, however, over time the activist shareholder comes to better understand the organization's longer-term strategy and the existing board comes to understand the activist shareholder's views as well. When it works, these opposing views can be reconciled and the benefit to the organization can be significant. This is exactly what happened when an activist shareholder took a strong position in the Family Dollar stock and negotiated a board seat as a result. Pamela Davies, a Director at Family Dollar, explains:

> *The early skepticism that the board felt for its newest board member cast him largely as an outsider focused only on a short-term profit goal without regard for the longer-term performance of the company. Over time, however, the barriers to understanding one another broke down, and the board began to work collaboratively toward what was arguably a much better outcome for the company.*[9]

In this instance, the board was able to reclaim a more dynamic culture because all of the directors were able to find common ground.

> *When it works well, it is my belief that an activist shareholder with an open mind and a willingness to listen to the existing board's rationale can bring value to the company by sharing his or her views on the company that come through a different lens. Yes, activists can be extremely disruptive, both to the board and the management team. But if managed effectively, they can also contribute greatly to the performance of the company if the board culture is adaptable, and a common vision, along with common ground, can be found.*[10]

CEO Leadership Style

Of the three elements we have noted that impact board culture, the leadership style of the CEO has the most impact on board dynamics and culture. Yes, the board's overall culture ultimately determines the dynamics of the board, as do the individual personalities of board members, the overall health of the business, external economic conditions, and the competitive and regulatory environment faced by the organization. Those factors notwithstanding, the style of the CEO directly impacts the board in a number of ways, including access to senior management and critical information, and a certain degree of process management during the actual board meetings. Again, as the old adage reminds us, one person cannot create success alone, but one person can do a lot of damage.

Research into CEO leadership style and its impact on board performance is limited. Research in this area won't allow us to draw any consistent conclusions for the creation of a single set of board governance "best practices" related to style because of so many complex, competing factors that impact business performance. However, there are some findings that are relevant for this discussion, and they deserve some degree of caution in interpretation. For example, the personality characteristic of "Narcissism," which is the trait of being selfish, proud, and vain, should have negative outcomes, right? Well, not necessarily.

Narcissistic Leaders

Sometimes even the most narcissistic leaders create positive results, while in other cases these traits produce negative, ineffective organizational outcomes. That's because situational context is everything. Researchers have noted that there are two kinds of narcissists: productive and unproductive. Productive narcissists are visionary, bold, charming, charismatic, and courageous. In the right positive environment, these characteristics support the success of a leader and his or her company. However, in a difficult or challenging business environment, these same characteristics lead to failure, because a lack of self-awareness leads to unrealistic goals, delusions of grandeur, and paranoia. For example, former HealthSouth Corp. CEO Richard Scrushy has been cited by Sue Shellenbarger as an example of a manipulative personality, a "classic, good salesman."[11] He is charismatic and charming but also very difficult on those who confront or disagree with him. He was fired by the board in 2003 after regulators uncovered a multibillion dollar accounting error, and he ended up serving prison time for fraud and bribery.

Example of Context

Here's another example that demonstrates how context trumps any preconceived notions about the positive or negative impact of a particular leadership style. A controlling, autocratic leadership style might be more effective during a time of crisis or to lead a corporate turnaround strategy, despite the many downsides to this leadership style. Boards charged with finding a leader to steer their company through difficult times should always gauge leadership style in the context of the challenge faced. This same principle also applies to the process of identifying board leaders.

Stanford researchers David F. Larcker and Brian Tayan point to the critical role of context in their 2013 article, “Where Experts Get It Wrong: Independence vs. Leadership in Corporate Governance.” The article cites the publicly reported disagreements aired in 2004 when the Disney Corporation's board stripped then-CEO Michael Eisner of his chairmanship. Shareholders objected to Eisner's performance and management style, depicted widely in the media as “brilliant,” “domineering,” and “combative.”[12]

Five Characteristics of High-Performing Boards

Many factors impact board performance, including five characteristics of high-performing lead directors:

1. Understand the business.
2. Have the right expertise, background, and unique insight to fulfill their role.
3. Are willing to invest the necessary time and energy on the board and the company.
4. Have a strong working relationship with the CEO.
5. Ensure that the board's culture is “dynamic” and blends collegiality with candor.

Larcker and Tayan write that current CEO and chairman Robert Iger's personality—described as “modest” and “exhibiting good judgment and grace under fire”—is very different from Eisner's. They argue that “independence” of the CEO and Chairman position for the sake of independence, without consideration of personality and style and the larger macro-environment, misses the most important elements of leadership effectiveness and, ultimately, corporate performance. This example illustrates both the impact of personality and leadership style on effectiveness, and perhaps more importantly, on the culture and performance of the board.[13]

A Lead Director Network (2010) update suggested that irrespective of individual personalities, environmental challenges, and CEO style, there are five defining director characteristics that determine board performance, and they follow.[14]

The Leadership and Board Performance Cycle

Appreciating board culture and group dynamics requires understanding what creates and sustains the board's unique personality or culture. Board culture is created and sustained primarily by three discrete components: the personalities of the individual directors, the broader context or macro-environment in which the company operates, and the style of the lead director. Although there is ongoing debate about which element impacts board culture the most, research indicates that the leader's style is the most important.[15]

Impact of Style

It is vital to highlight the impact of a leader's style on board culture. To really understand board leadership and to create a “dynamic” culture with higher levels of director engagement, collegial candor, and pathways to effective decision making requires a much more nuanced examination: first, of the four lead roles—chair, nonexecutive chair, lead director, and presiding director—and, second, of the four distinct leadership styles based on the dominant motive or need of the leader:

- *Achiever* (Achievement Need)
- *Affirmer* (Affiliation Need)
- *Asserter* (Power Need)
- *Actualized* (Self-Actualization Need)

Board and Group Definition

We use “board” and “group” interchangeably in this chapter and define them as three or more people who share a common goal, since physical proximity is not necessary to meet this definition of a group or a board. Likewise, directors may spend very little time physically together, but because they share a common goal, language, and affiliation, they meet the definition of a group and are subject to the principles of small-group behavior.

From a board governance perspective, it is critical to note that each of the four leadership styles creates and fosters a unique board culture. Three of the four leadership styles—*Achiever*, *Affirmer*, and *Asserter*—create a less than optimal board culture and directly impact communication, problem solving, decision making, and, ultimately, director engagement.

The Detached Culture—Achiever Leadership Style

The sad irony in life is that individuals who have a very high need for achievement, *Achievers*, create the lowest performing culture—*Detached*. Because of their need for absolute perfection, *Achievers* sweat every detail while micromanaging their teams. This dynamic plays out in the boardroom as well. *Achievers* are often too bogged down in the details and attempt not only to manage but also often to micromanage the business.

As a result, this culture is grounded in emotions of anger and apathy, and the resulting impact on the board from a group dynamics perspective is detachment. Directors express anger either aggressively, with open conflict and personal attacks, or passively, by disengaging psychologically or physically. Psychological disengagement manifests when directors become more interested in their mobile phones, iPads, or laptops than in the board meeting. Physical disengagement occurs when directors habitually arrive late, leave early, or miss meetings altogether. Whether the anger is expressed actively or passively, directors in a *Detached* culture are not in the optimal position for engaging in candid discussions, healthy debate, and rational decision making. The most likely group decision-making pitfall facing this board culture is *Groupthink*, which will be discussed in the next chapter.

The Dramatic Culture—Affirmer Leadership Style

Now, imagine the extreme opposite end of the spectrum from a *Detached* culture and replace anger with kindness, rudeness with politeness, and despair with hope. At first this kind of board culture might sound more appealing, but it often results in the same degree of poor decision making and director disengagement. The *Dramatic* culture is created and sustained by leaders who are primarily motivated out of the need for affiliation, who are *Affirmers*, and who focus on maintaining warm, harmonious, interpersonal relationships. These leaders want and need to be accepted and approved by the board at all costs. To this end, the board norm is one of politeness and friendliness to the extreme. Difficult or uncomfortable discussions are avoided or tabled for "off-line" conversations that rarely occur. Although it is warm and personally supportive, the *Dramatic* culture lacks collegial candor and frankness. Members often self-censor to avoid breaking the group norm of politeness and agreement.

This culture is grounded in the emotion of frustration. Directors are friendly and polite on the surface, but this norm of "niceness" supersedes the need for healthy debate and conflict. Because candor and conflict are often avoided, directors often leave meetings feeling frustrated and exasperated with the lack of progress or action. The most common group decision-making pitfall with the *Dramatic* culture is *The Abilene Paradox*, which will be discussed in the next chapter.

The Dependent Culture—Asserter Leadership Style

It stands to reason that the majority of business leaders have a high need for power and thus exhibit the *Asserter* leadership style. The resulting culture developed and sustained by this style is *Dependent.* This is the most common culture in Corporate America, whether in Fortune 500 companies or nonprofit organizations. The *Dependent* culture is grounded in fear and anxiety, with its chief attribute being *caution.*

As previously discussed, the *Asserter* style is results oriented and effective in the short term, especially during a crisis. However, this style and the fear that it engenders is not sustainable, and the long-term impact is quite dysfunctional. In a *Dependent* culture, directors look to their powerful leader for assurance, relying too heavily on his or her previous “track record” of accomplishments. Under stress, this leadership style can be dominating and autocratic, often shutting down attempts at open communication when it is needed most.

Managing Up

Although *Asserters* are often extremely candid and blunt, they do not appreciate or tolerate any dissension. Members hesitate to speak out or to challenge the leader, which often leads to poor decision making. This culture is often difficult to identify because *Asserters* are very adept at “managing up,” meaning that they create and maintain favorable impressions with their boss, but often at the expense of their team and direct reports. Thus, while the organization may suffer, they often enjoy a favorable impression from the board. It is critical for directors to engage other members of the senior management team to assess the impact of the leader's style on the organization as a whole. The norm of this culture is to “follow the leader,” and as a result, the board decision making for a *Dependent* culture often leads to either *Groupthink* or *The Abilene Paradox.*

The Dynamic Culture—Actualized Leadership Style

Leaders who are driven primarily by the need for Self-Actualization often exhibit seemingly contradictory elements in their style. For example, they may be charismatic in a public setting, but often they long for solitude. *Actualized* leaders care deeply for their teammates and their organizations, but that does not inhibit them from making difficult decisions or providing real-time feedback.

Unlike the *Affirmers*, who default to politeness, *Actualized* leaders default to candor. Unlike *Achievers*, who prefer routine and predictability, *Actualized* leaders are spontaneous and enjoy novelty. And, unlike *Asserters*, who crave control and have trouble trusting others, *Actualized* leaders humbly share their power and ask for input, while implicitly trusting others to make decisions and take appropriate actions. While *Actualized* leaders have a high need for achievement, care about their teammates, and are candid and decisive, they exhibit unique characteristics that create and sustain a *Dynamic* board culture.

For example, they understand the business but are not at all interested in getting bogged down in irrelevant details or trying to micromanage the board. They are strategic and conceptual, and they accept ambiguity and uncertainty as part of life. *Actualized* leaders tend to be more realistic and quick to “confront the brutal facts,” while trusting others and always being willing to ask for help, input, and guidance. Although they share many of the characteristics of *Asserters*, they use their power for the best interests of the organization as opposed to personal ego gratification. These leaders share focus on the strategic and unknown, but they do not feel compelled to be in control or to always be “right.” Finally, and perhaps most importantly, *Actualized* leaders see the world from a sense of abundance as opposed to scarcity, and their motivation has profound impacts on culture.

The Leadership Cycle

Clearly, the *Actualized* leadership style creates the highest performing *dynamic* board culture that is characterized by open, candid communication and high levels of engagement and board and organizational commitment.[16] Actualized leaders welcome diverse opinions and are adept at questioning their own assumptions about the internal organization and the broader, external environment. The leader and board members treat each other in a respectful, collegial manner and have meetings that are more efficient, since candor allows for honest discussions and debate. All of these qualities allow the board to focus on its primary role of guiding the business toward success.

The leadership cycle shown in Figure 4.2 illustrates the impact of the leader's style and the resulting degree of his or her directive activity on board culture and performance.

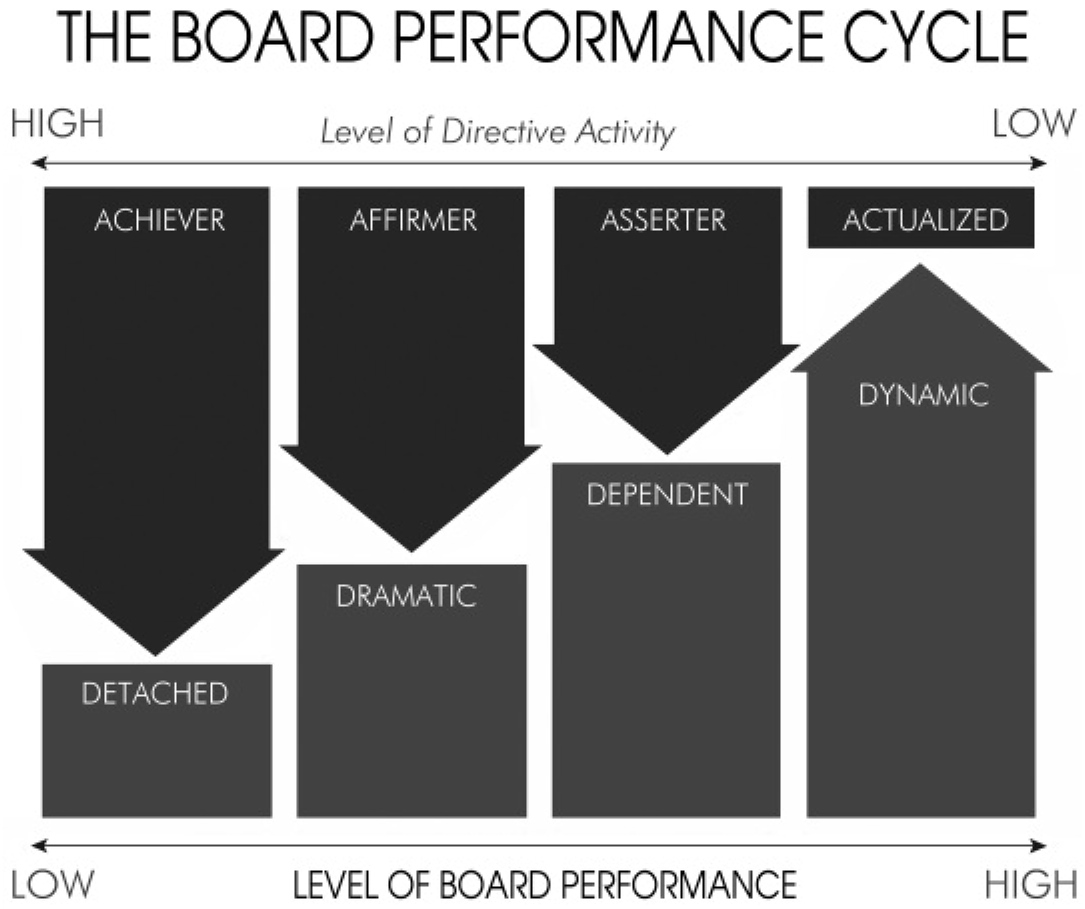
THE BOARD PERFORMANCE CYCLE
HIGH
Level of Directive Activity
LOW
ACHIEVER
AFFIRMER
ASSERTER
ACTUALIZED
DYNAMIC
DEPENDENT
DRAMATIC
DETACHED
LOW
LEVEL OF BOARD PERFORMANCE
HIGH

Figure 4.2 The Board Performance Cycle

Transforming Board Culture

Transforming individual attitudes and preconceptions in ways that impact behavior is not easy; the path to change for a board leader is no different than anywhere else and requires the same three conditions:

1. Recognition on the part of the board that change is needed.
2. Recognition on the part of the leader (e.g., lead director, presiding director, nonexecutive chair, CEO, etc.) that his or her leadership style is creating and reinforcing a less than optimal culture, and an expression by the leader of a sincere desire to change.
3. An honest and candid assessment of the "current state" and a commitment, on the part of the board, to create an action plan for making the necessary changes in order to achieve the desired results—a more *Dynamic* culture.

Transforming the *Detached* Group Culture

The *Detached* culture is the least effective level of group development and culture. It often leads to poor decisions as a result of *Groupthink*. Below are suggested practices and steps to help transform a *Detached* culture:

- Provide candid feedback to the lead director and/or CEO, letting him or her know the impact of his or her style on the board's culture.
- Allow the lead director to acknowledge and vent his or her anger and frustration, often best accomplished with a formal board assessment.
- Resolve issues of power, authority, and responsibility among the lead director, the CEO, the board as a whole, and committees.
- Develop and implement board decision-making processes that facilitate director engagement, candid input, and frank discussions.
- Ensure that all directors participate in and adopt a "no cell phones" policy to ensure that all members are participating equally.

Transforming the *Dramatic* Group Culture

The *Dramatic* culture represents a lower level of group development, in which members are committed to each other but often at the expense of the group's performance. This culture is marked by excessive idealism, conflict avoidance, and unrealistic expectations for the future. The decision-making pitfall most common in this instance is *The Abilene Paradox*, and the following strategies can be implemented to transform the *Dramatic* culture:

- Consider showing *The Abilene Paradox* video or providing the article about it so that board members understand and relate to the concept of “mismanaged agreement.”
- Encourage directors to provide honest and critical feedback to the lead director, the CEO, or the board as a whole.
- Confront the group about poor performance, unrealistic expectations, or obvious problems.
- Set challenging or even audacious performance goals for the organization and group standards for the board.
- Appoint individual members to serve as “devil's advocate” to critique the group's performance, plans, and decisions.

Transforming the *Dependent* Group Culture

The *Dependent* culture represents the most common group culture, in which members soften their true opinions or practice outright self-censorship. This culture is marked by excessive reliance on the board's leader, and the following strategies can be implemented to transform the *Dependent* culture:

- Involve all board members in developing specific goals and assessing performance of the lead director, the board, and the organization.
- Set and adhere to a schedule that facilitates director interaction with all members of the senior executive team, and encourage senior executives to make presentations to the board.
- Allow members to clarify and communicate their roles and expectations to the entire group, including any frustrations that they may be experiencing.
- Encourage the lead director and/or the CEO to delegate more effectively.

Maintaining the *Dynamic* Group Culture

The *Dynamic* culture represents the highest level of group development and board performance. Members are rational and responsible, and they communicate directly and honestly with each other. There is a high level of engagement with the board and the overall organization, and directors are committed to each other. The following strategies are suggested to maintain and optimize a *Dynamic* culture:

- Focus on healthy debate and discussion, and encourage candid feedback.
- Protect the board from too many external distractions or influences.
- Celebrate organizational successes and achievements.
- Provide the necessary resources for the board to perform at optimal levels.

Understanding board culture and group dynamics and applying these suggested strategies will help ensure that your board is candid, respectful, and engaged. As cited earlier, Jeffrey A. Sonnenfeld found that the conventional wisdom that focused only on structure and procedure was less impactful than efforts based on the realization that boards are "social systems." As such, just as much attention should be paid to building trust and encouraging candor as to schedules, procedures, and process.[17]

Chapter Summary

Group culture is the essential determinant of effective board communication, problem solving, and decision making. As we have outlined, boards that develop and maintain *Detached*, *Dramatic*, or *Dependent* cultures are much more likely to suffer from dysfunctional patterns of communication and, as such, engage in ineffective problem solving and group decision making. Understanding the impact that the “leader” has on board culture, whether the leader is a CEO or lead director, is crucial for assessing and improving director engagement and board performance.

What's Next?

Chapter 5, “Group Dynamics and Board Decision Making,” will explore board decision making and the two classic group decision-making pitfalls: *Groupthink* and *The Abilene Paradox*. We will offer a framework for predicting which dysfunctional group decision-making dynamics your board is most likely to experience, based on your board's culture, and proven strategies for effectively bypassing these common, and often costly, mistakes.

Notes

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6. Solange Charas, “The Impact of Board Dynamics on Shareholder Value Creation.” *Director Notes*, The Conference Board, February 2014: 1–8.

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16. Sparks, “Group Culture and Basic Assumption Mental States.”

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CHAPTER 5
GROUP DYNAMICS AND BOARD DECISION MAKING

What's in This Chapter?

- Why Working in Groups Is Difficult
- *Groupthink:* Managing Conflict in the Boardroom
- *The Abilene Paradox:* Managing Agreement in the Boardroom
- Optimizing Board Decision Making
- Chapter Summary and What's Next

As we noted earlier in this book, board decision-making practices should be focused on the most important aspects of corporate governance: *Is the right CEO in place? Is the company pursuing the right strategy? Is the succession plan current and viable?* In addition to these three main questions, boards also make critical decisions related to mergers, acquisitions, divestitures, compensation, and shareholder issues.

Accomplishing this mission, as simple as it appears from the outside, is more challenging than you might imagine, because successful decision making depends on the ability of board members to work together effectively. Since human factors and communication processes are involved, working together cooperatively toward the same goals is more difficult than it might at first appear. As we discussed in the previous chapter, the ultimate goal is to develop and maintain a *Dynamic Culture* that encourages honest, collegial debate and candor among board members, which, in turn, will lead to reasoned, rational decisions. Such an environment naturally improves both individual and group communications, and leads to better decisions, since emotion-driven reactions (perceived or real), peer pressure, or irrational thinking can have dire—even catastrophic—consequences for the organization.

The purpose of this chapter is to examine the group dynamics that impact board decision making. Our discussion will focus on the two classic pitfalls of group decision making—*Groupthink* and *The Abilene Paradox*—and we will offer strategies that will improve the quality of board decision making. In addition, this chapter offers some practical tools that help to measure and improve the overall performance of boards, along with some strategies to improve the level of director engagement while optimizing board decision making.

Why Working in Groups Is Difficult

Group decision making has long been an important subject of research. We can trace research on this topic back to the 1800s, when the renowned French sociologist Emile Durkheim famously asserted that the “mentality of groups is not that of individuals.” Durkheim was referring to “mob mentality” and his concerns over the lack of rational decisions made by groups.[1] Influenced by Durkheim, Sigmund Freud also found that the feelings of a group, any group, were always “simple and exaggerated.” Freud stated that groups could only experience love or hate, and were unable to live in the “grey” of ambiguity and complexity.[2] In his seminal book *The Crowd*, Gustave Le Bon asserted that “ . . . in the collective mind the intellectual aptitudes of the individuals, and in consequence their individuality, are weakened. The heterogeneous is swamped by the homogeneous, and the unconscious qualities obtain the upper hand.”[3]

Modern researchers have conducted numerous studies to illustrate the often negative and counterproductive aspects and outcomes of group decision making. One of the most famous studies, which has since been replicated many times, was that done by Solomon Asch in 1952.[4] Asch demonstrated the impact that group norms have on conformity behaviors, demonstrating that individuals operating in a group setting take more extreme positions than they would if they were alone. His famous research asserts that individuals would knowingly commit errors and agree with the larger group as a result of perceived conformity pressure. More recently, research by Cass R. Sunstein and Reid Hastie has confirmed these original findings by illustrating that groups often not only take more extreme positions than they would if they were acting alone but also fail to achieve any sense of “synergy,” because they fail to aggregate their collective knowledge when making decisions.[5]

Factors to Consider

There are several factors that contribute to the overall culture and group dynamics of the board, including the size, cohesiveness, and diversity of the board (see Figure 5.1). Each will be discussed as it relates to group decision making in the boardroom.

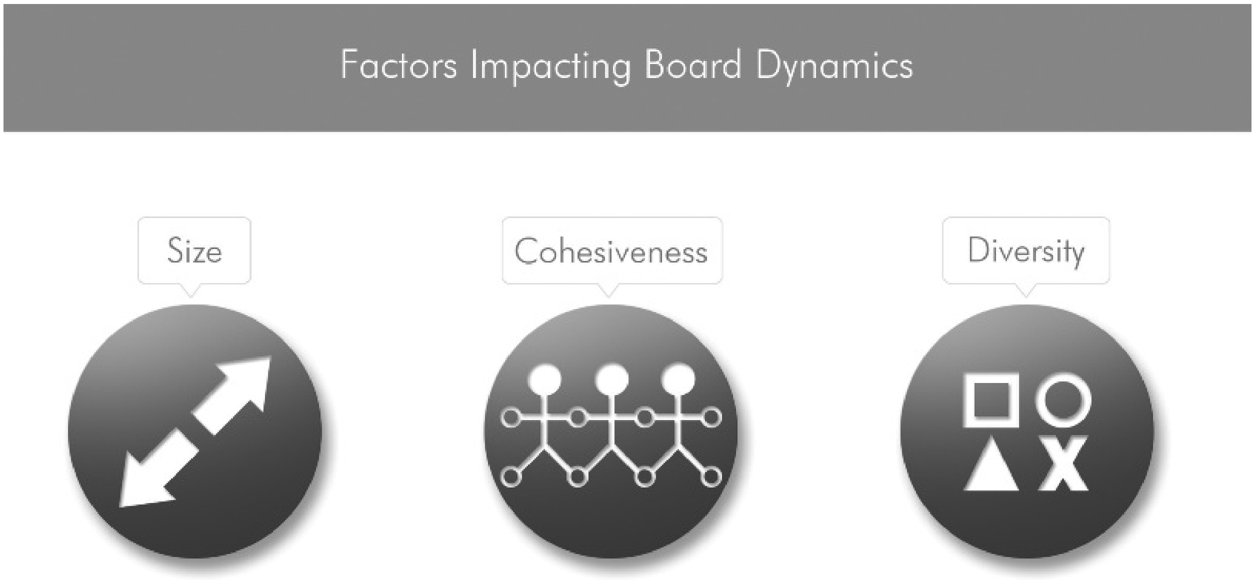


Figure 5.1 Factors Impacting Board Dynamics

Size

The average S&P 1000 board size is approximately ten directors. Obviously, the size of the board varies based on a number of factors. What is critical to remember is that a trade-off occurs from a group dynamics perspective when the size of the board increases. “Social loafing” is the concept used to describe a common and less-than-optimal aspect related to group decision making: *as the size of the board increases, individual director engagement and participation decreases.* This is not unique to boards, and it's not personal; it just is. This finding, sometimes referred to as the “free-rider tendency,” is a natural outcome of group behavior. As the size of the group increases, members believe that “someone else” will know more or do more to provide a solution, suggestion, or recommendation to a given issue. As previously stated, there are many and diverse reasons for increasing the size of a board. You need to carefully weigh those advantages, however, with the very real dangers posed by this phenomenon.

Board Cohesiveness

Board cohesiveness refers to how committed the directors are to each other and to the organization they serve. Not surprisingly, as group cohesiveness increases, so too does productivity, performance, and, in a reinforcing cycle, director engagement. Boards that suffer from a lack of cohesiveness often have developed a *Detached* or *Dependent Culture*, in which members have different agendas, ambiguous goals, or are part of a board that is too large in number. Several factors, such as frequent interactions, getting together outside the boardroom (either socially or on-site at a plant or facility location), and a clear goal or challenge can increase a sense of cohesiveness and, in doing so, create a more *Dynamic Culture.* Sometimes a common enemy, such as a hostile takeover bid or a competitor, will also facilitate a rapid sense of cohesion.

Importance of Diversity

Diversity is the third factor that informs and impacts group decision making. Diversity in every sense—race, gender, skill set, experience, opinions, and perspectives—will help ensure that your board matches the complexity and diversity of the global marketplace. A note of caution: diversity and heterogeneity often lower performance in the short term. When directors see things differently or don't feel that they are “on the same page,” there is a lag in performance. However, over time these differences move from being tolerated to being appreciated, and they help boards make thoughtful, reasoned decisions in an increasingly complex and diverse global economy.

Decision making is common to every group whose members attempt to work collaboratively together, as we pointed out in the previous chapter, and how well (or poorly) a group coalesces has a lot to do with its unique culture. Culture ultimately determines the degree of communication, the level of director engagement, and the quality of decision making. Boards with culture problems generally fall into one of two extreme categories:

- *Detached*—cold and angry
- *Dramatic*—warm and friendly

These two distinct and very different cultures result in two very different dynamics and processes, but they ultimately lead to the same outcome: a bad decision.

How a board arrives at a decision, however, is distinct. *Detached* cultures facilitate conflict—passive and aggressive—and a board's inability to manage this conflict often results in the dysfunction of “Groupthink.” Boards with a *Dramatic Culture*, in which the culture is warm and friendly but lacking in candor, are often unable to manage their agreement and suffer from “The

Abilene Paradox.” The travel routes of *Groupthink* and *The Abilene Paradox* are very different, but the destination—a poor decision—is the same.

Groupthink: Managing Conflict in the Boardroom

Boards that have devolved into an angry or apathetic *Detached Culture* exhibit *Groupthink* behaviors, as noted by Yale University's Irving L. Janis. In general, *Groupthink* occurs when groups are frustrated and ineffective in managing conflict, so they focus on pressuring members to “get with the program” or “be a team player.”[6]

A *Dramatic Culture* is characterized by the exact opposite group dynamics. In this culture, conflict and candor are replaced by warm agreement and self-censorship. Unfortunately, both cultures guarantee poor decision making, since the false consensus exhibited by a *Dramatic* culture leads the board to take inappropriate actions. This false consensus, characterized as *The Abilene Paradox* by Jerry B. Harvey, leads to the same result: a failure to communicate and to solve problems effectively.[7]

That's why a board's independent director and the CEO must understand these group dynamics and ensure that neither dynamic—*Groupthink* or *The Abilene Paradox*—has any influence on high-risk decisions that are critical to the success of the organization. Here are classic examples of *Groupthink,* and Figure 5.2 summarizes the subtle differences between *Groupthink* and *The Abilene Paradox* in board decision making.

Classic Examples of *Groupthink*

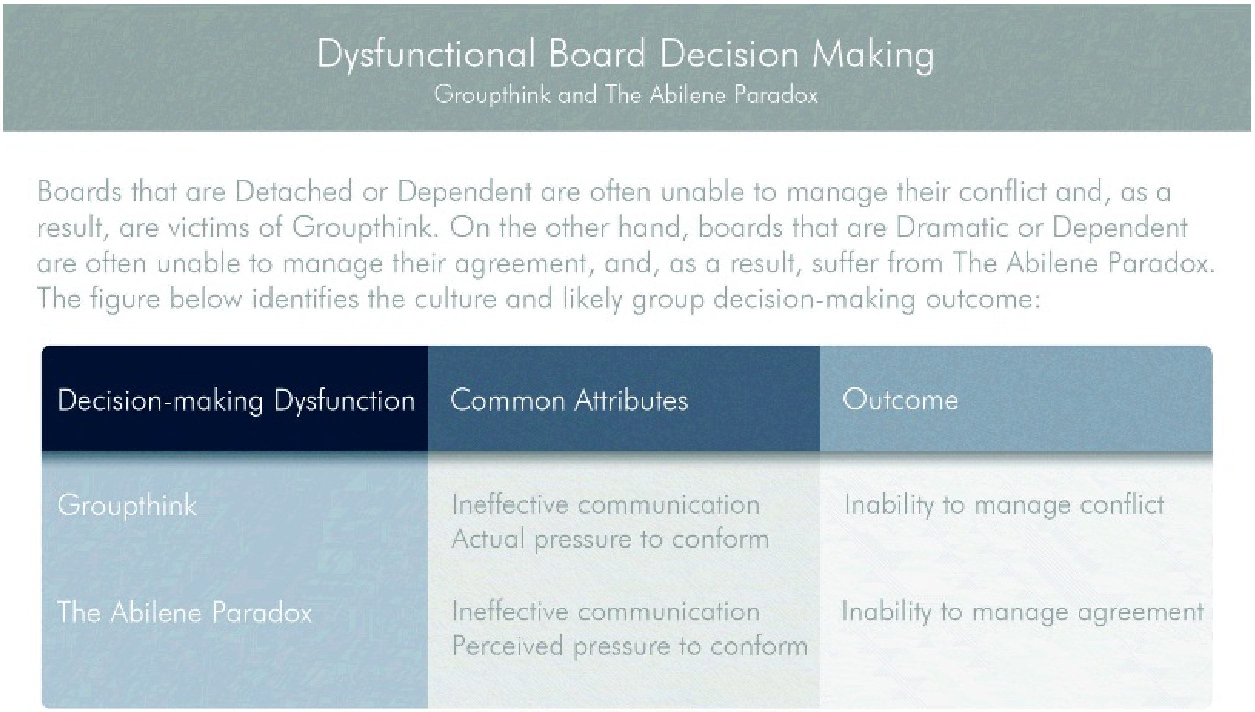
Classic examples of *Groupthink* from history include the Bay of Pigs Invasion and NASA's decision to launch the Challenger in 1986.

Bay of Pigs Invasion

The chain of events leading up to the failed Bay of Pigs invasion of Cuba in 1961, in which U.S.-trained and equipped soldiers attempted to overthrow Fidel Castro, is a classic example of *Groupthink.* President Kennedy wanted to overthrow Castro, and his subordinates knew it because he inserted himself directly into the deliberations. As a result, his “group” was not thinking rationally or objectively. Instead, the members of his “group” jumped to conclusions, self-censored, and jumped to recommendations that almost led to conflict with the former Soviet Union.

1986 NASA Challenger Tragedy

Prior to the launch of the Challenger in 1986, Morton Thiokol engineers, who were responsible for manufacturing the O-rings for the booster rockets, expressed concern about the O-rings sealing quickly enough at the predicted lower temperatures. NASA administrators applied direct pressure on the engineers to recommend a launch, based on perceived media pressure due to recent delays. Although the engineers had serious concerns, they gave in to the pressure and recommended the launch.



Dysfunctional Board Decision Making

Groupthink and The Abilene Paradox

Boards that are Detached or Dependent are often unable to manage their conflict and, as a result, are victims of Groupthink. On the other hand, boards that are Dramatic or Dependent are often unable to manage their agreement, and, as a result, suffer from The Abilene Paradox. The figure below identifies the culture and likely group decision-making outcome:

Decision-making Dysfunction	Common Attributes	Outcome
Groupthink	Ineffective communication Actual pressure to conform	Inability to manage conflict
The Abilene Paradox	Ineffective communication Perceived pressure to conform	Inability to manage agreement

Figure 5.2 Pitfalls in Board Decision Making

Understanding and Avoiding *Groupthink*

In 1972 Irving L. Janis identified *Groupthink* as a mode of thinking that occurs when a group's strong desire for cohesion and unanimity prevents it from realistically appraising other alternatives or options. Oftentimes, conformity or peer pressure ensues so that any group member who voices dissent is quickly reminded that the group norm is consent.[8]

Eight symptoms of *Groupthink* have been identified, so the more of these characteristics that exist in a boardroom, the more likely it is that the board will be a victim of *Groupthink.*

1. **An Illusion of Invulnerability:** The board believes that it is invincible and can do no wrong, and past “wins” are often cited as proof of future success.
2. **Rationalizing Valid Concerns and Warnings:** The board makes a collective effort to minimize or rationalize warnings that run counter to the board's desired outcome.
3. **Belief in the Group's Inherent Morality:** The board has an unquestioned belief that it holds the “moral high ground.”
4. **Stereotyped Views of Outsiders:** The board views external voices as enemies who have little or no value to add because they are “outsiders.”
5. **Direct Pressure Exerted on Members to Conform:** The board as a whole provides direct peer pressure on members who voice dissenting views or opinions.
6. **Self-censorship of Individual Beliefs and Feelings:** Individual board members begin to self-censor their true beliefs and feelings that run counter to the norm of consensus.
7. **Self-appointed “Mind Guards”:** Individual board members actively block or withhold outside information that could contradict the current path of consensus.
8. **Shared Illusion of Unanimity:** Individual board members falsely perceive that everyone is in agreement and that there is unanimous consensus.

The process of *Groupthink*, if identified and acknowledged, can be managed and even avoided if boards are willing to have an open, honest dialogue about the issue. Recognition and acknowledgment are key first steps, but alone they are not enough to prevent *Groupthink.* The following suggestions are some effective ways of preventing *Groupthink*:

- Assign members the role of critical evaluator or “devil's advocate,” especially to assess their own proposals and recommendations.
- Engage external experts (e.g., CFOs, industry experts, etc.) to provide critical reactions and environmental context.
- Set up another independent group to study a pressing issue and to consider both the group's assumptions and recommendations.
- Periodically break the group into subgroups in order to address process issues within the larger group.
- Take the time to study the larger context within which the group is operating, including conducting board and director assessments.

Getting Past *the Abilene Paradox*

Jerry B. Harvey challenged the notion that poor decision making is always the result of *Groupthink* in his seminal 1974 article, “The Abilene Paradox: Mismanaged Agreement.” According to Harvey's research, groups don't always make poor decisions because of peer pressure. Instead, Harvey wrote, groups often make poor decisions due to a failure of individual members to communicate honestly and directly with each other.[9]

To illustrate his point, Harvey used both historical examples (such as the Nixon-era Watergate debacle) and personal examples to illustrate the principles of *The Abilene Paradox*. For example, he described a four-hour car trip in 104-degree weather from Coleman to Abilene, Texas (hence the name of the paradox), with his new wife and in-laws in a car with no air-conditioning, all to eat a bad dinner in a cafeteria. His observation later that evening was that no one, not even his father-in-law who had suggested they go to Abilene, really wanted to go, yet no one said anything as the road trip disaster unfolded. Below are some boardroom examples of this paradox.

The Abilene Paradox in the Boardroom

1. Directors agree in a private (not a public) forum about the nature of the situation and what they want to do about it.
2. Directors fail to accurately communicate their thoughts, feelings, desires, and/or beliefs to each another in a group setting. This requires the director to self-censor his or her true beliefs and feelings in order to “go with the flow” or “get on board” with the board.
3. Invalid and inaccurate information leads board members to make collective decisions that are contrary to their individual opinions and views.
4. The board “agrees” on a decision or course of action based on faulty information that no director privately supports.
5. Board members experience frustration, anger, irritation, and dissatisfaction over poor decisions that range from less than optimal to disastrous.

Harvey remarked that it is “pretty absurd isn't it, people taking actions in contradiction to what they really want to do?” Yet, most of us can cite more than a few examples of this group decision-making process occurring. Harvey eventually identified the psychological and group dynamic principles that enable *The Abilene Paradox* to occur, as listed below:

1. Action Anxiety:One of drama's most famous characters, Hamlet, famously mused, “To be or not to be, that is the question” as he pondered suicide. Action anxiety occurs when we are unsure of which action to take; we often shut down and do nothing.
2. Negative Fantasies:Negative fantasies are the dire, predicted outcomes we mentally construct that provide a basis and justification for not speaking up or not dissenting with the board. Such fantasies often range from thinking that we may be ostracized from the board to fearing we may not be renominated.
3. Fear of Separation:A primal, existential fear of being alone, being separated from others, often motivates us to “agree” to a course of action in a group setting when we privately have concerns or misgivings about that course of action. As Harvey correctly illustrates, giving in to this fear often leads to experiencing what Viktor Frankl referred to as “paradoxical intent” and what he called a “paradox within a paradox”: the more we fear anything, the more likely we will experience it, including separation.
4. Real Risk:Real risk is at play when a board member departs from the board or group norm of agreement. Harvey referred to this risk as the “price of admission” for being human and acknowledged that sometimes the fear of being ostracized, of not being a team player, or of not being renominated must be weighed accurately and objectively when deciding to voice one's true opinions.

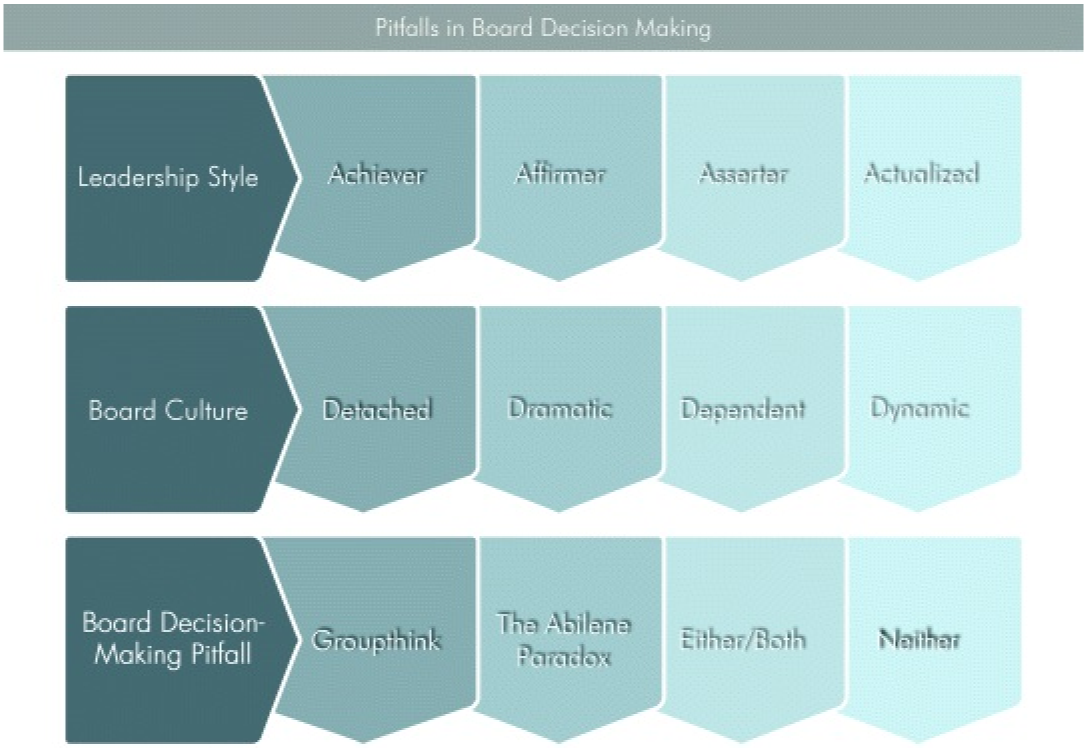
Diagnosing *The Abilene Paradox*

As with *Groupthink*, there are recognizable symptoms of *The Abilene Paradox* that, once identified, can be managed. Harvey recommends the following norms and “ground rules” to help groups, and boards, avoid *The Abilene Paradox*:

- Establish and reinforce the norm of collegial candor, not politeness.

- Treat conflict as not only normal but also necessary, in order to make optimal decisions and to achieve synergy in a board setting.
- Establish the ground rule that everyone must participate and that total engagement in the process is not only expected but also required.
- Avoid being insulated. Bring in “outsiders” from time to time to provide expert input and analysis.
- Don't rush making a major decision. Time is a reflection of priorities; when a major decision, such as strategic direction or succession planning, is in order, take the necessary time to reach a reasoned and thoughtful decision.

As you consider your board dynamics and group decision-making effectiveness, it may be helpful to review the matrix shown in Figure 5.3. Based on the leadership style and group culture descriptions in the previous chapter, you can begin to predict which, if any, decision-making dysfunctions your board may be susceptible to, or is experiencing, right now.



Pitfalls in Board Decision Making

Leadership Style	Achiever	Affirmer	Asserter	Actualized
Board Culture	Detached	Dramatic	Dependent	Dynamic
Board Decision-Making Pitfall	Groupthink	The Abilene Paradox	Either/Both	Neither

Figure 5.3 The Leadership, Culture, and Decision-Making Matrix

Starting with the leadership style of the CEO, you can begin to reflect on the impact that he or she may be having on your board's culture and dynamic. If the CEO is more *Actualized* and, from a “Big 5” personality perspective, more “Agreeable,” then you likely have open discussions in which candor and collegiality abound. However, if your CEO's style is more micromanaging (*Achiever > Detached > Groupthink*), more accommodating (*Affirmer > Dramatic > Abilene Paradox*), or more controlling (*Asserter > Dependent > EITHER Groupthink OR Abilene Paradox*), then your board is more likely to suffer from group decision-making dysfunction.

Optimizing Board Decision Making

Even if your board has a *Dynamic* and effective culture, you must be vigilant to ensure that your board makes optimal decisions. The goal is to ensure that there is high-quality discussion, with a blend of candor and collegiality, a strong sense of engagement and connection to the business and to each other, and an intentional effort to maximize the collective wisdom of the directors to enhance and improve board decision making. In addition to the specific suggestions already provided for addressing common dysfunctions in board decision making, following are broad steps that your board can take to ensure that it is making sound, reasoned, and rational decisions.

- Ensure That Everyone Participates:Invite participants who are less vocal to lead or start certain discussions. Create a norm in the boardroom of going around the table to solicit input and to make sure that everyone expresses his or her true opinion.

- Silence the CEO:Many CEOs—some unknowingly, and others on purpose—discourage debate and disagreement by stating their positions and views early in a discussion. Research clearly demonstrates that when leaders speak last, they create more “space” for open dialogue and candor.

- Reinforce Candor, Not Politeness:It's nice when everyone gets along, but that type of culture can also create trouble. Develop a norm of authentic candor where constructive conflict becomes a healthy means to a better end, including thanking or otherwise reinforcing the board members who bring up difficult topics.

- Test Assumptions:Board members often share so many common traits and values that it is easy for them to develop and act on assumptions.

Effective boards test their collective assumptions from time to time by asking “what if” questions.

- Appoint a Devil's Advocate or Contrarian:By formally appointing someone to play devil's advocate, you effectively give the director “permission” to challenge the group, propose alternative courses of action, and identify faulty logic or assumptions in a proposed course of action. This technique can be very effective, and the position should be rotated among board members.

Successful boards require the wisdom, energy, and collective synergy that come from highly engaged board members operating as a team. Regardless of the success or sophistication of any particular director, the common pitfalls associated with group dynamics and board decision making must be identified and managed effectively. Structure, process, and procedures can and do help improve communication and decision making. However, it is important to remember that boards are social systems and thus susceptible to human failings, such as self-censorship and detachment, which often occur in group settings. Boards that manage their process dynamics and culture will be better able to fulfill their responsibilities to shareholders, customers, and employees by avoiding *Groupthink* and “trips to Abilene,” through better decision making and synergy.

Chapter Summary

This chapter examined the group dynamics that impact board decision making by focusing on two classic pitfalls of group decision making: *Groupthink* and *The Abilene Paradox*. It offered strategies to improve the quality of board decision making, along with some practical tools to help measure and improve the overall performance of boards. The chapter also provided strategies to improve the level of director engagement while optimizing board decision making.

What's Next?

Chapter 6, “Board Structure and Schedule,” provides some practical guidelines to help determine a board's size and structure, when and how to meet, along with some tips on scheduling successful board meetings.

Notes

[1] Emile Durkheim, Emile, *The Division of Labor in Society* (New York: Macmillan, 1933), 19.

[2] Sigmund Freud, *Group Psychology and the Analysis of the Ego*, trans. J. Strachey (New York: W. W. Norton & Company, Inc., 1950), 11.

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[7] Jerry B. Harvey, The Abilene Paradox and Other Meditations on Management (San Francisco: Jossey-Bass, 1988).

[8] Irving L. Janis, Irving L., Groupthink: Psychological Studies of Policy Decisions and Fiascoes, 2nd ed., (Boston: Wadsworth, Cengage Learning, 1982).

[9] Jerry B. Harvey, *The Abilene Paradox and Other Meditations on Management* (San Francisco: Jossey-Bass, 1988).

CHAPTER 6
BOARD STRUCTURE AND SCHEDULE

What's in This Chapter?

- Determining Board Size and Structure
- Frequency of Meetings and Required Preparation
- Board Committees and Practices
- Scheduling Board Meetings
- Chapter Summary and What's Next

In many ways, the corporate board of a publically traded company is the ultimate “free agent.” Although it's true that corporate boards do have an absolute set of fiduciary duties and expectations that they must attend to, ranging from approving operational motions and statutory filings to a careful scrutiny of a company's annual plans and budgets, it is also true that there are no hard-and-fast, industry-wide guidelines that govern the execution of these duties. For that matter, boards are not bound by any specific guidelines regarding the number of members or number of meetings that they must have or any rules on the mix of talents, skills, and backgrounds that are required for optimal efficiency and productivity.

This lack of hard-and-fast, industry-wide guidelines is both good and bad news for those serving on a corporate board. The good news is that boards do have wide latitude to set the number of directors at whatever count they wish and to establish their own ground rules for conducting business using the most efficient processes and procedures. The bad news is that this same gift of freedom makes it difficult for the board to know when it “gets it right.” This is the question that we address in this chapter—and frankly, this book—how to “get it right.”

This dichotomy was noted recently by David L. Larcker and Brian Tayan in their 2013 *Stanford Closer Look Series* article, “Where Experts Get It Wrong: Independence vs. Leadership in Corporate Governance”:

> *While there is evidence that governance processes are critical to success*

> *—such as proper risk management or a workable CEO succession plan —it is the quality with which processes are designed and implemented rather than as the mere presence of a program that determines whether they will be successful.*[1]

Put another way, the most successful boards use this freedom to construct specific on-the-ground processes that add value to the company and help it to fulfill its fiduciary duties effectively. This chapter tackles the issue of creating an optimal board structure and schedule, and in so doing we address the following topics:

- Board Size
- Meeting Requirements and Preparation
- Effective Committee Service
- Board Scheduling Tips

Board Size

The average size of a typical S&P 500 board—about 10.8 members—has remained remarkably stable over the past ten years, as reported in Spencer Stuart's 2014 Board Index.[2] Depending on the industry, company size, and past practices, board membership ranges from as large as twenty or more to as small as five or six. As we noted in this chapter's opening comments, the number of serving board members is a completely open question, but like most decisions, there can be both intended and unintended consequences, depending on the choice of an either exceptionally large or small board.

For example, a large board may provide the desired range of expertise and experience, but along with increasing size, a set of more complex dynamics in relationships between board members emerges. This is especially true when membership exceeds ten or eleven members. The lead director also faces greater challenges when ensuring full participation and real consensus among members as the size of the board increases. Still, there are circumstances in which a larger board membership is required, as in the case of a more complex business, such as a large financial institution or a highly regulated company (e.g., an energy company). In these cases, a large board may be needed to fill additional committees in order to satisfy specific regulations or to meet the board's due diligence mandate.

The focus on board size and membership may seem mundane or even a prosaic use of a board member's valuable time, but the decisions made about size, mix of skills, and overall committee structure will have a significant impact on a board's success and productivity, and the fulfillment of its fiduciary duties.

The issue of board composition and the best skill mix will be addressed in greater detail in Chapter 9, “The Other Succession Challenge: The Board of Directors,” but it is important to note that the issue of board size and composition should be front and center during every board transition.

Meeting Requirements and Preparation

Most large companies require formal in-person board meetings between four and six times a year. General Electric and United Technologies each require eight scheduled board meetings per year according to their proxy material, while Proctor & Gamble requires seven scheduled meetings per year. Again, as noted in Spencer Stuart's 2014 Board Index, S&P 500 companies met on average 8.1 times in 2013; however, it should be noted that this number included any extraordinary additional in-person or telephone meetings to address such matters as acquisitions, divestitures, or contact with an activist shareholder.[3]

Although it might appear that six or even eight formal board meetings a year is a reasonable schedule for the chief executive officer (CEO) and the CEO's team to manage, it's the “behind the scenes” activities that make even four annual meetings a “full-plate” commitment for everyone involved in preparing for, and participating in, these meetings.

What is often forgotten by both board members and even those who are critical of a board's performance is the amount of time that it takes management to prepare for presentations in front of a board and its respective committees. After all, the CEO is meeting with his or her bosses, who determine not only the CEO's compensation but also how long the CEO will stay in office. No one goes into such meetings unprepared. Preparation is especially critical, because any question that a board member might ask, whether it is about an issue related to acquisitions or mergers, or about a significant strategic issue such as cyber security, is based on years of experience and deep knowledge. Looking foolish or uninformed about a particular issue or set of facts in front of the board is simply not an option.

The consequence of this pressure to perform is that a significant amount of time and energy is invested in rehearsal and practice to arrive at a “carefully rehearsed spontaneity” when responding to the board. It's a process that takes a considerable amount of time and effort by multiple people.

Board Meeting Preparation

Generally, board meeting material is electronically delivered just before or on the weekend leading up to the board meeting. Distribution of the material too early risks that the material won't be fresh in the board members' minds during the meetings, and delivery of material that is too late risks the possibility that board members won't have sufficient time to prepare for the board meeting.

The ability to deliver board materials electronically up to the last minute, despite the positive aspect of currency, also adds another complication to the process. Updated material that's delivered on the fly may have the unintended impact of leaving some members unprepared to fully participate in the meeting. As a guideline, board materials should always be sent within a time frame that allows members sufficient opportunity to read and understand the information. In practical terms this means that board material is normally sent out one or two days before the weekend prior to the week in which the board meeting occurs.

As noted earlier, rehearsal and practice are necessary for the management to develop “carefully rehearsed spontaneity” when answering questions based on board meeting materials. Arriving at this polished state of understanding does take time and effort, so time the sending out of materials accordingly.

The Realities of Preparation

Large companies that require more than six formal meetings a year often have specific staff dedicated to the preparation of board meetings. Such arrangements reduce the time that management spends on these meetings and frees them up to focus on important business activities, that is, spending time with customers, clients, employees, investors, and shareholders, and building relationships for possible acquisitions, mergers, or other strategic matters.

Even with the help of a board meeting staff, supplemental meetings will still be required that demand careful preparation by senior management. It is no trivial matter to decide how many of these formal meetings are best suited for a particular company's board. That's why companies often employ carefully considered meeting frequency and timing strategies to maximize the opportunity to deliver on important company operational requirements, such as producing approved quarterly results from the audit committee or approving quarterly 10Q or 10K documents required by the Securities and Exchange Commission (SEC). Such regulatory activity may require the audit committee to meet separately from the formal board meeting (normally by phone) up to eight additional times each year.

Some boards have revised their board schedules to better coincide with these audit committee responsibilities in order to avoid the need for the additional committee meetings and thus reduce workload. Still, committee work often requires input or even approval from the larger board membership, and these responsibilities add to the time required of members.

For example, a member of the senior management team usually works closely with the chair of each committee to prepare for a meeting either in person or by phone. This usually means a review of the agenda to obtain the committee chair's approval as well as a “review of all the material intended for a committee meeting.” Once again, this task is critical to prepare for the meeting in order to avoid the appearance (and embarrassment) of being unprepared for questions or unable to give meaningful input.

How Many Committees Are Needed

Unlike many areas of board structure, committee structure does have specific requirements, provided by the New York Stock Exchange Listed Company Manual. The stock exchange listing requirements explicitly call for these standing committees, described below, respectively, in sections 303A.04, 303A.05, and 303A.07:

- Listing companies must have a nominating/governance committee composed entirely of independent directors.
- Listed companies must have a compensation committee composed entirely of independent directors.

The audit committee must have a minimum of three members. All audit committee members must satisfy the requirements for independence set out in Section 303A.02.a.

About Executive Committees

It's quite common for a board to have on executive committee normally consisting of the nonexecutive chair, presiding director, or lead director, whatever their structure, and the

chairs of the three required committees and the CEO. Before the events of 2001–2002, many boards found that the executive committee, particularly in the case of large boards, had turned into a board within a board (not a good idea). In those circumstances, the full board was asked to vote on issues recommended by the executive committee before the board members had a good opportunity to fully understand and debate the issues before them.

What has developed since that time is the utilization of the executive committee by exception to meet or convene between formal board meetings, acting, for example, as a pricing committee for a new issue of corporate debt. Under these circumstances, the board votes to empower the committee to act on its behalf.

A review of proxies that notes how often committees meet will generally show few if any meetings of the executive committee. In this new world of board governance, it's important that the full board be engaged on virtually every issue facing the board and the company. Conference calls make it possible and should be used between meetings, including extraordinary items to include and engage the full board.

According to Spencer Stuart's 2014 Board Index, companies average 4.2 standing committees. Seventy percent of companies have at least four committees, and 14 percent of companies have six or more committees. Some of these additional committees focus on topics such as finance, safety, health and environmental affairs, innovation and technology, corporate social responsibility, and/or risk.[4]

One of the challenges of multiple committees (more than four) is the requirement for more board members to fill out the committee assignment; generally three or more committee members are needed to take advantage of the dynamic give-and-take and opinions voiced by members. Another challenge is scheduling time for four or more committee meetings in order to allow sufficient time for the committees to fulfill their obligations.

When major strategic and structural change occurs, including a significant acquisition, a major merger of equals, or dealing with a cyber attack, the response is often to establish an ad hoc committee to address the specific issue at hand. Once the issue is resolved, the board must decide if it makes sense to continue the ad hoc committee, so when these special committees are formed, a board should carefully consider both their creation and dissolution.

Committees of the Whole

Some boards have found the approach of "committees of the whole" to be a very effective way of managing committee formation and information dissemination. Essentially, this approach requires all board members to serve on all of the committees of the board. Such an approach means that every board member is part of all discussions and debates, whether the topics are compensation matters, audit committee issues, or governance and nominating committee matters, and is therefore fully informed of all board activities. As a result, committee reports to the full board do not require detailed explanations and background in order for action by the full board to take place.

Another benefit of this approach is that board members can spend extensive time together discussing, debating, and approving issues in committee meetings. These meetings allow respective board members to learn how to work together and to develop confidence in the judgment and candor of other board members. This understanding of different styles, logic, experience, and capacity to communicate can be very valuable when the full board is faced with a critical issue, such as a merger, acquisition, CEO successor, or dealing with an activist shareholder.

A variation on the "committee of the whole" approach is to utilize the governance and nominating committee. Its agenda is generally the shortest and least complicated while it covers issues that the full board should address anyway. Companies that utilize this model integrate this committee meeting into the agenda of the full board meeting. The result is a simpler committee meeting schedule while providing another opportunity for all the members of the board to interact with one another.

Effective Meetings and Service

Many variations on board schedules exist, and most evolve over time to suit the character of the business, the company, and the culture of the board. What is most important is that both the board and the CEO (along with the CEO's team) develop a rhythm and pattern that allows sufficient time for the critical ongoing discussion of strategy and its execution.

With variations there are basically two different models for board meeting schedules. In the first type of board meeting schedule, members gather at midday, possibly for lunch, followed by committee meetings throughout the afternoon. A board dinner concludes the day. Some boards meet alone with the CEO, while a more typical practice is to include the other members of senior management or individuals who have made or will be making a presentation to the board. With boards that meet formally only four to six times a year, the board needs as much exposure to the members of the management team, including prospective CEO succession candidates, as possible.

A very good and effective practice (although certainly not universal) is for the board to meet alone with the CEO for breakfast early in the morning (7:00 or 7:30 a.m.). A set or specific agenda is not necessary; rather, the breakfast meeting provides an opportunity to have an open, unstructured conversation around what's on the CEO's mind and the minds of the members of the board.

After the breakfast meeting, the regular board meeting begins and concludes around lunchtime. If at all possible, the day should end with an executive session of the independent directors.

Another potential meeting schedule begins with the board's arrival on the evening preceding the day of the board meeting. Dinner is an opportunity for board members to mix with members of the senior management team, although some boards periodically meet alone with the CEO during the dinner.

The next morning is occupied with committee meetings, followed by the full board meeting, which concludes the day. One of the problems with this schedule is that by the end of the day, many board members are looking at their watches, worried about their departure schedules. Under these circumstances, holding an effective executive session of the independent directors can be and is a challenge.

Still other companies follow a different meeting path. For example, one Acuity Brands organizes board meetings that begin with a dinner for all the independent directors, who gather with the CEO, chief financial officer (CFO), and chief operating officer (COO). The meeting structure allows for socializing and catching up on each other's activities, as a preparation for the next day and a half of meetings. The following morning is occupied by simultaneous meetings of the audit and compensation committees.

Lunch, under this meeting structure, is a roundtable conversation and question-and-answer session with the CEO, CFO, and COO, who update the board on the latest developments in the industry and in the company. The afternoon is dedicated to an update and question-and-answer session from business segments or functional department heads in the company.

The dinner allows the board members to engage with those making the presentations and other members of management at their table, with seating assignments that will ensure a good mix of directors and management. The next morning begins with a breakfast with the CEO and the independent directors, followed by the formal board meeting, which is usually completed well before lunch, as most of the business issues already have been addressed.

The bulk of the meeting time is spent on the formal approval of necessary items, including the governance and nominating committee placed on the board's agenda. While such a schedule does require two nights at the company office or an outside company location, it allows sufficient time for board members to understand critical strategic issues and questions, as well as to stay in touch with key members of the management team at many levels.

Chapter Summary

No two boards are the same. What works for one board may not work for another. What is important is that a board periodically review how it organizes itself around the size of the board, the mix of skills of the independent directors, and the number of formal meetings that are needed to organize the appropriate schedule. A groove can turn into a rut, so stepping back periodically to assess these structural questions is an important step to ensure that a board can effectively fulfill its fiduciary duties.

What's Next?

Chapter 7, “Assessing Board Performance,” outlines the evolution of board assessments, particularly in light of the passage in 2002 of the Sarbanes-Oxley Act and the NYSE's changes that same year to its Listed Company Manual, requiring “nonmanagement directors” to meet separately from the CEO. You'll learn practical ways to customize assessments to better match your company's processes and board culture, along with tips on conducting peer reviews.

Notes

[1] David F. Larcker and Brian Tayan, "Where Experts Get It Wrong: Independence vs. Leadership in Corporate Governance," *Stanford Closer Look Series*, March 2013, www.gsb.stanford.edu/faculty-research/centers-initiatives/cgri.

[2] 2014 Board Index, Spencer Stuart, Inc. Accessed July 29, 2015, www.spencerstuart.com/~/media/PDF%20Files/Research%20and%20Insight%20PDFs/SSBI2014w

[3] 2014 Board Index, Spencer Stuart, Inc.

[4] Ibid.

CHAPTER 7
ASSESSING BOARD PERFORMANCE

What's in This Chapter?

- The Evolution of Board Assessments
- Examples of Board Assessments
- Customizing the Assessment Process
- Finding Your Own Best Practice
- Conducting Peer Reviews
- Chapter Summary and What's Next

Asnoted in Chapter 1, “The Changing World of Board Governance: How We Got Here,” 2002 was nothing short of a watershed year for board governance practices, mainly due to two events. First was the passage of the Sarbanes-Oxley Act (SOX), which focused on governance activity within corporate boards and audit committees. Second was a significant change in the New York Stock Exchange (NYSE) Listed Company Manual (303A.03), requiring that “nonmanagement directors meet at regularly scheduled executive sessions without management.” These changes to governance practices were in direct response to public outrage over corporate malfeasance and greed that had been so unabashedly exhibited by three high-flying corporations at the time: WorldCom, Enron, and Tyco.

This chapter discusses another important 2002 change to the NYSE Listed Company Manual, which requires annual performance reviews of the board and its committees. As provided in Section 303A.09 of the NYSE Listed Company Manual, boards “should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively” as well as “an annual performance evaluation of the required committees of the board—Nominating/Corporate Governance, Compensation and Audit.” The requirement also called for an assessment (done within the corporation's Compensation Committee Guidelines) of how well the CEO is adhering to the reviewed and approved corporate goals and objectives set by the board.[1]

While this may be a reasonable request on its face, the NYSE Listed Company Manual unfortunately provides no directions as to how the assessment should be conducted, implemented, or administered; nor does it give any guidance on the comprehensiveness of the assessment, what questions should be asked, or what records should be maintained. The guidelines also do not mention or give any guidance on required peer assessments.

The Evolution of Board Assessments

Prior to the 2002 change in the NYSE's Listed Company Manual, few companies conducted annual board and committee assessments. Dayton-Hudson (the predecessor to Target), home improvement retailer Lowes, and Nucor Corporation (the largest U.S. steel producer, based in Charlotte, North Carolina) are exceptions, having implemented these assessments as early as 1990. For these earlier adopters of board assessments, written questionnaires were used, and it was not uncommon for these companies to even share their experiences, forms, and assessment approaches with one another.

However, in general, these and other companies conducting board assessments at the time utilized a questionnaire format that was administrated for the full board by or through the governance and nominating committee, with each of the other committees conducting their own assessments. A chief executive officer (CEO) assessment, if it was done at all, was generally managed by either the compensation committee or the governance and nominating committee. Today boards pursue a wide variety of practices based on each board's perception of what has worked in the past, the shared experience of other board members, or insight gained through board governance seminars and/or the advice of consultants.

Further impetus to focus on these board assessments came in 2009 when the Securities and Exchange Commission (SEC) implemented a rule for proxy disclosures that required boards to expand any disclosures regarding directors' individual skill sets and diversity, and to better describe overall board composition and their board members' qualifications for board service. This disclosure, along with growing activist shareholder pressure for more scrutiny, prompted boards to provide an outline of how they conduct annual assessments in their proxy communications.

Examples of Boards Assessments

Nucor Corporation's proxy is a good example of how many companies now provide their annual assessment disclosure in response to the NYSE's 2009 assessment disclosure directive. In the company's 2014 proxy under the headline, “Annual Evaluation of Directors and Committee Members,” appeared the following statement:

> *The Board of Directors evaluates the performance of each director, each committee of the Board, the Chairman, the Lead Director, and the Board of Directors as a whole on an annual basis. In connection with their self-evaluation, each director anonymously records his or her views on the performance of each director standing for re-election, each committee and the board of directors. The entire Board of Directors reviews their reports and determines what, if any, action should be taken in the upcoming year to improve its effectiveness and the effectiveness of each director and committee.*[2]

What is not required in the disclosure, but still very much part of the process, is the assessment of the CEO's performance in addition to that of the executive chairman.

The 2014 proxy of General Electric (GE) offers further insight into how other companies view and implement their board assessment efforts. In GE's case, the proxy details can be found under the headline, “Evaluation Process,” and offers the following explanation of the process:

> *Each year, either the lead independent director or an independent, third party governance expert, interviews each director to obtain his or her assessment of the effectiveness of the Board and committee, as well as director performance and Board dynamics, and then, after discussion with the chair of the GPAC, summarizes their individual assessments for discussion with the Board and committees. [In years when a third party governance expert conducts the interview, the expert will also discuss this with the lead director before submitting them for Board discussion.]*[3]

Customizing the Assessment Process

One of the tenets of this book—that no two boards are the same—clearly applies to the board assessment process. As the Nucor and GE examples illustrate, companies use a wide variety of assessment practices, and each reflects the values, preferences, and culture of a particular board.

The lack of guidelines provides both an opportunity and a challenge for the board. The opportunity is the potential to create a customized assessment process that works for the board and its culture. The challenge is to not allow any established assessment process to devolve into a state of "just checking the boxes" so that the process no longer addresses fundamental issues or potential governance changes that would improve the effectiveness of board governance.

Where to Start

The best way to approach the topic of creating a process for board assessment is to assume a "tabula rasa" and start from scratch. This can be accomplished by asking a few basic questions, such as the ones below, about the nature of the assessment, the goals and outcomes of the assessment process, and what makes the most sense for the board:

- When should the assessment take place? Should it be an annual questionnaire or some other instrument?
- Who should gather the information? Should a third party or an annual board roundtable discussion be used, during which the performance of the board, the company, and the CEO are discussed?

Many companies rely on an outside law firm or compensation consultant to gather the responses and then return the responses to the company as a report, without attribution.

As we've noted repeatedly, there are no right or wrong answers to these or any other questions about board governance. However, it is important to make sure that the processes created candidly address the necessary tough questions in ways that contribute to the board's ability to fulfill its fiduciary duties. In addition, the focus must be kept on key questions concerning strategy and effective implementation of that strategy, the effectiveness of the CEO, and other essential questions, such as managing any risks to the company.

The questions that the board asks reflect these company-wide concerns both directly and indirectly, in questions such the following:

- Does the board have the right meeting schedule and receive the correct information between meetings and the pre-board-meeting materials?
- Does the board have the right number of directors or the mix of skills, backgrounds, and diversity as appropriate?
- Is the process for the selection of new directors satisfactory?
- Does the board have adequate time to meet with the CEO?
- Are board meetings conducted in a manner that ensures open communication, particularly for a full discussion and timely resolution of issues?
- Is the leadership of the independent directors effective?
- Are the board members adequately prepared for board meetings?

As we described in Chapter 5, “Group Dynamics and Board Decision Making,” good board chemistry and board dynamics are critical to effective board performance. If these two factors exist, boards operating within the resulting positive and collaborative atmosphere will get more out of the process. Experience also suggests that a thoughtful, formal, and rigorous approach to board evaluation yields results that are higher quality and actionable.

Finding Your Own Best Practice

Our approach for assessing board performance is a combination and also an integration of some of the best practices adopted by companies that we have worked with over the years. Still, boards must determine what process and method best suits their needs without losing sight that it's less about the actual survey or assessment and more about the candid feedback and dialogue that the assessments generate. It is within these performance discussions that true value and insight are gained.

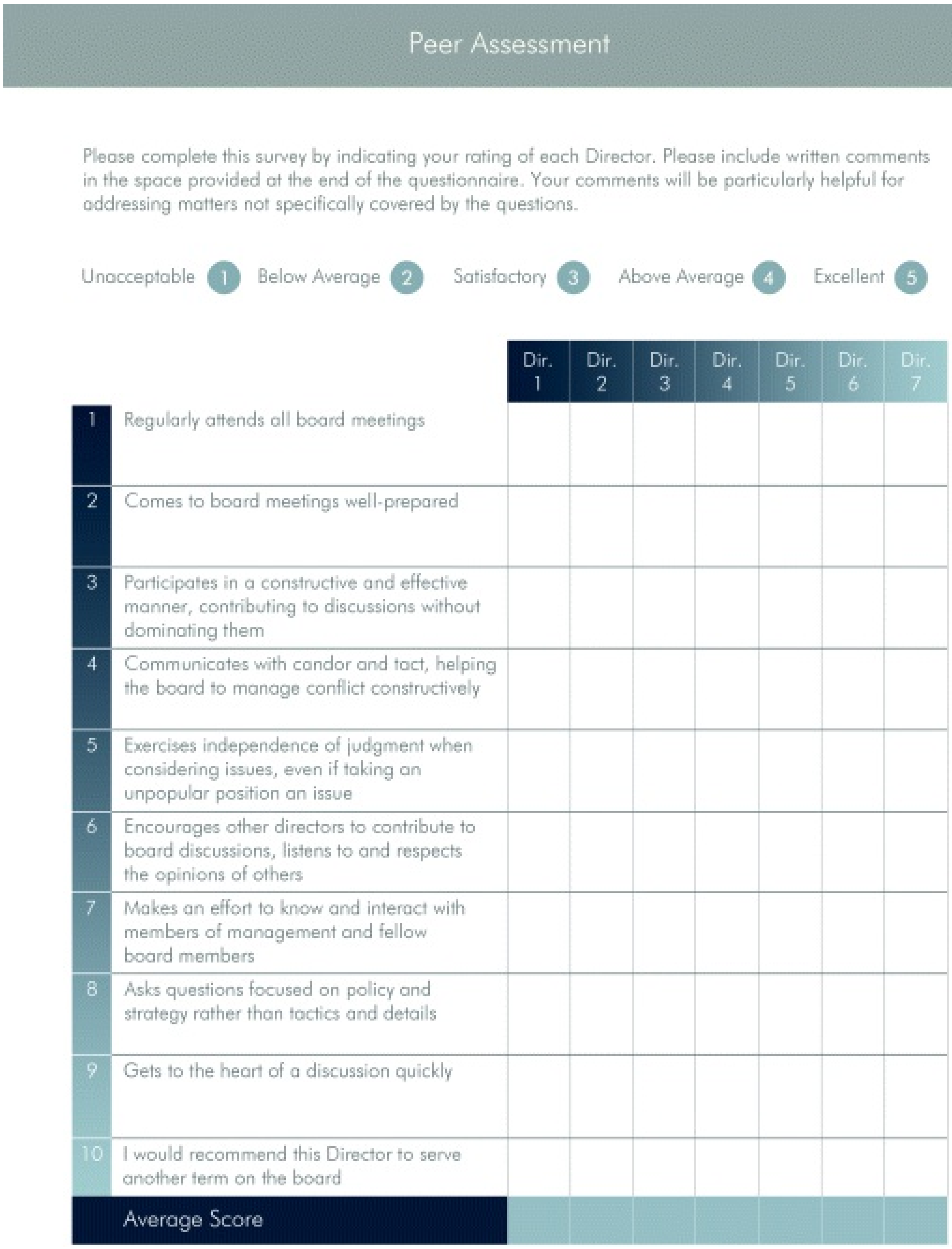
Impact of Board Culture

Board culture, as we've discussed throughout this book, has a big impact on effectiveness. Clearly, a dysfunctional board culture seriously impacts the value of board assessments. Just how much culture impacts communication and decision making is difficult to measure and quantify in any consistent way. That's why we suggest the use of our *Board Culture Profile*, a copyrighted board assessment form that is included in Appendix A. Among other benefits, the model found in Appendix A can help determine if the board is likely to engage in board decision making that is guided by the principles of either “Groupthink” or the “Abilene Paradox” (see Chapter 6, “Board Structure and Schedule,” for more information), essentially a “go-along” mind-set or being influence by the phenomenon of false consensus. Our approach focuses on traditional aspects of director engagement and board performance, which we believe are essential to measure and are the ones that provide the greatest insight into the underlying culture of the board. It's an approach that allows directors to quickly get to “the heart of the matter” in a way that facilitates candor, respect, and change. (See the Appendices to find specific questions for assessing board, director, lead director, and committee and CEO performance and effectiveness.)

Conducting Peer Reviews

According to Spencer Stuart's 2014 Board Index, 34 percent of the S&P 500 companies are now conducting individual director evaluations.[4] Steven R. Walker's National Association of Board Directors (NACD) blog on August 28, 2012 reported at the time that 48 percent of the companies responding to his survey included individual director evaluations.[5] Clearly, board assessment is gaining more support and is moving away from the early days of board assessment, when many directors had a difficult time accepting the idea that they would be subject to feedback regarding their performance as a director.

The way peer feedback is conducted varies just as widely as the format and process varies for board assessment. Here is an example of the questionnaire approach (see Figure 7.1), reproduced from Appendix H.



Peer Assessment

Please complete this survey by indicating your rating of each Director. Please include written comments in the space provided at the end of the questionnaire. Your comments will be particularly helpful for addressing matters not specifically covered by the questions.

Unacceptable 1 Below Average 2 Satisfactory 3 Above Average 4 Excellent 5

		Dir. 1	Dir. 2	Dir. 3	Dir. 4	Dir. 5	Dir. 6	Dir. 7
1	Regularly attends all board meetings							
2	Comes to board meetings well-prepared							
3	Participates in a constructive and effective manner, contributing to discussions without dominating them							
4	Communicates with candor and tact, helping the board to manage conflict constructively							
5	Exercises independence of judgment when considering issues, even if taking an unpopular position on an issue							
6	Encourages other directors to contribute to board discussions, listens to and respects the opinions of others							
7	Makes an effort to know and interact with members of management and fellow board members							
8	Asks questions focused on policy and strategy rather than tactics and details							
9	Gets to the heart of a discussion quickly							
10	I would recommend this Director to serve another term on the board							
	Average Score							

Figure 7.1 Peer Feedback Form

Source: **Peter Browning Partners**

In the example shown in Figure 7.1, the directors assess each other's performance across a list of attributes, statements, and questions. Other directors provide constructive feedback on a wide variety of criteria, including preparation, constructive debate participation, and willingness to take an unpopular position on an issue. In aggregate, the completed profile should provide an informed view on how directors rate each other's performance as a member of the board. As illustrated in the figure, the results are displayed anonymously, without attribution.

If scores or other indications reveal a particular director who is not meeting the performance level of the other directors, it is the responsibility of the lead director and/or the CEO and lead director to meet with and discuss the performance review's results. As we'll discuss in Chapter 9, “The Other Succession Challenge—The Board of Directors,” a peer assessment is very helpful in a discussion with an underperforming board member.

Other Peer Review Options

Using a third party or the lead director to interview each board member and using a list of performance characteristics does not significantly change the process. Depending on the structure and practice of the board, the full set of assessments once completed can be reviewed by the governance and nominating committee on behalf of the board when that committee is not established as a “committee of the whole” (a board structure in which all board members serve on all committees, as discussed in the previous chapter).

In general, although it is certainly not always the case, the nonexecutive chairman, lead director, or presiding director leads the committee or preferably the entire board in reviewing the outcome of the assessments. These matters are really the purview of the entire board, and a constructive, open written or verbal discussion around the outcome of the assessment should take place and include the board, the CEO, the chairman or lead director, and, if in place, the peer review committee.

Chapter Summary

Board assessments have become the norm. As with so many repetitive practices, assessments can turn into “one more process to deal with before the board can turn to more important matters.” Although it's true that familiarity “can breed contempt,” it is incumbent on the lead director and the CEO to reinforce the importance of the process before it begins. Even more important is for the committee chairs, the lead director, and all of the directors to take advantage of the outcome of the assessments, in particular the open-ended questions and comments. Everyone involved in the process should view these assessments as an opportunity for candid self-evaluation of their practices and behaviors in order to ensure their own adherence to the highest performance standards.

What's Next?

Board members, by definition, have spent their careers achieving well-recognized, hard-earned success as CEOs, CFOs (chief financial officers), or leaders in other fields. It is this demonstrated individual achievement that has brought them to the board in the first place. But how do you maintain a healthy balance between the strongly held opinions of individual members and the need for consensus? Chapter 8, “The Challenge of the Disruptive Director,” addresses a common situation that many boards face: how to handle a director whose behavior, practices, or style disrupts the vital board chemistry to such a degree that the director's departure is necessary for the continued functioning of the board.

Notes

1. NYSE Listed Company Manual, 2002. Accessed August 1, 2015, http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3_10&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

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5. Steven R. Walker, National Association of Board Directors, August 28, 2012.

CHAPTER 8
THE CHALLENGE OF THE DISRUPTIVE DIRECTOR

What's in This Chapter?

- Disruptive Members a Common Issue
- Removing Board Members
- The Ying and Yang of Conflict
- Five Types of Disruptive Directors
- Dealing with Disruptive Directors
- How Assessments Help
- Chapter Summary and What's Next

It is not surprising that a gathering of highly motivated, engaged, driven individuals has a built-in potential for disagreement and conflict. After all, board members, by definition, have spent their careers achieving well-recognized, hard-earned success as chief executive officers (CEOs), chief financial officers (CFOs), or leaders in other fields. It is this demonstrated individual achievement that has brought them to the board in the first place.

Maintaining a healthy balance between the strongly held opinions of individual members and the need for consensus in such a group is no small accomplishment. The best and most dynamic boards maintain authentic collegiality, and members have respect for one another while at the same time freely engage in candid debate and constructive disagreement with one other. Serving on such a board with this rare collegial chemistry can be fulfilling, but it can become a draining and frustrating experience when this collegial chemistry is missing.

This chapter addresses an all too common situation that many boards face: how to handle a director whose behavior, practices, or style disrupt this vital board chemistry to such a degree that the departure of that director is necessary for the continued functioning of the board.

Disruptive Members a Common Issue

In their book, *Boards That Lead—When to Take Charge, When to Partner, and When to Lead*, Ram Charan, Dennis Carey, and Michael Useem note that boards often face the challenge of a disruptive member. “In our experience, as many as half of the Fortune 500 companies have one or two dysfunctional directors,” the authors assert in their book.[1] We would agree with this assessment based on the popularity of the topic at board governance conferences, in workshop offerings, and in traditional and social media discussion groups that are focused on board governance. This “statistic” is also supported by my experience of serving on the boards of thirteen publicly traded companies over the past twenty-seven years.

How does a board deal with the thorny issue of telling an otherwise smart and successful board member that his or her services will no longer be required? How does the board manage the bruised ego of someone who is not used to failure or to being confronted with the news that his or her behavior or performance has been judged disruptive and unproductive by fellow board members?

“Firing” Board Members Not Simple

Directors are usually elected by their shareholders annually, which is becoming the prevalent practice, or triennially as part of a staggered board to serve as a peer with fellow directors. In either circumstance, boards cannot “fire” fellow directors during the middle of their term. If a director should leave before the director's term has expired for whatever reason—disagreement with a board decision, health or family challenge—the SEC requires the company to file Form 8K on behalf of the director, explaining the reason for the departure as approved by the director. In almost every case, a disruptive board member transitions off the board in a structured, procedural way.

Although the circumstances that I faced when I had to deal with a difficult or disruptive director are different and the process that we used to address the challenge varied, the outcome was the same: we were able to move the director off the board. Some board members dealt with the news by simply opting not to stand for renomination. Others submitted their resignation, with the face-saving explanation that their responsibilities outside the board had changed in a way that prevented them from continued service. Once the resignation was submitted, the board simply voted to accept the director's resignation. In some cases, disruptive or underperforming members were simply advised by the lead director that they would not be renominated by the governance and nominating committee.

The Ying and Yang of Conflict

Boards of directors of publicly traded companies are a unique and distinct microcosm. Elected by shareholders to represent their best interests, these highly accomplished, very successful individuals are mostly hyper, type A personalities. In the setting of the boardroom, they are all peers. Still, leadership roles within the board are required, including the selection of a leader for the chairs of various committees and the selection of someone to take on the role of the full board's nonexecutive chair (also known as lead director or presiding director).

Nevertheless, each board member carries the right to a single, all-important, “yes” or “no” vote, no matter how critical the issue or how vigorous the debate is. As in any group, certain members by virtue of their style, personality, or experience endeavor to exercise undue influence when decisions are being made, and it is these members whom boards must work with to encourage more collaborative ways of interacting.

Collegial candor and robust debate is absolutely critical for effective board dynamics and decision making. As discussed in Chapter 5, “Group Dynamics and Board Decision Making,” boards without enough conflict may be making poor decisions due to “Groupthink.” Boards that constantly seek to smooth over differences and default to agreement may be “on the road to Abilene.” One of the key antidotes to both of these dilemmas is a dissenting director who is willing to provide the board with timely information, differing viewpoints, and a healthy way to disagree. We would note that it is not unusual for dissenting directors to have strong opinions, but they should have the critical skill of being able to *disagree without being disagreeable.*

The extreme but wonderful example of an effective dissenter is Henry Fonda in his portrayal of the lead juror in the 1957 Oscar-nominated film, *12 Angry Men.* As the lead juror who is not convinced that the circumstantial evidence presented by the prosecution is enough to convict a son accused of murdering his father, Fonda must convince nearly all of the other jurors to adopt his point of view. Fonda's character pursues a classic course toward consensus building as each juror slowly changes his mind during the course of the movie.

An Effective Dissenter

Henry Fonda's character is an example of “an effective dissenter.” Board members who are effective dissenters are critical to any board's efficacy when the board is faced with challenging circumstances and issues that require open and honest dialogue to resolve them. Board members must make an effort to learn how to work together and appreciate the differing philosophies, styles, and personalities of the other members. It's this ability to effectively negotiate through disagreement that defines exemplary group dynamics.

The opposite of the director who is an “effective dissenter” is the “disruptive director.” Such directors are, as the cliché goes, “often wrong but seldom in doubt” and “never without an unexpressed thought.” It is not unusual to find such a personality pursuing his or her point of view with such intensity that the Chairman/CEO and/or lead director is unable to effectively facilitate the meeting. In such situations, over time these directors end up disrupting the rhythm and chemistry of the board, without adding to the quality of the board in any way. The board must decide if such a director is so disruptive to good process and productive outcome that the board would be better off without that director's presence.

Five Types of Disruptive Directors

Disruptive directors display little of Henry Fonda's sophisticated consensus-building techniques on display in the movie *12 Angry Men.* In fact, such directors generally fit into one of five categories of disruptive directors that unhinge the board's dynamic and/or derail healthy debate and discussion.

- The Dominator
- The Micromanager
- The Expert
- The MIA Director
- The Dinosaur Director

The Dominator

As a director, the dominator is an individual with a supersized ego, whose outstanding career was built on a “larger than life” personality. In general, this is the stereotypical egotistical personality who is outspoken and perhaps even a bit bullying with the other directors. This individual is the classic example of the true “disruptive director” and someone who, as we noted earlier, is “often wrong but seldom in doubt.”

The Micromanager

A detail-oriented director is someone who spends too much time “in the weeds” always seeking more data. While these individuals are well intended in their due diligence, too much information can sometimes be as disruptive as too little information. Still, it usually takes time for the board to develop a sense that such a micromanager is disrupting the flow of the board's conversations and debate. Furthermore, since inquiries for more information usually require additional work by senior staff, these micromanagers soon come to the attention of the company's CEO, who eventually sends some clear communication about the member to the board's lead director.

The Expert

Boards face a wide range of knowledge and informational challenges, so it is not unusual for them to decide that they would benefit from having a specific subject matter expert on their board. For example, a board may decide that it needs expertise on cyber security, Internet marketing, nuclear energy, or doing business in China. Quite often these are very constructive members who serve on a special committee that is formed to deal with a specific issue.

Clearly, the deep experience brought by these members can be helpful to the entire board and the management team. In some circumstances, however, there is a tendency on the part of these individuals to continue to refer back to their area of expertise again and again. It takes time for fellow directors to develop a consensus that the disruption outweighs the value of their expertise. The biggest challenge is that it is quite often easier to live with the behavior than to try to develop a consensus for whether or not to renominate the disruptive director.

The MIA Director

A director who fails to “show up” either physically or mentally is very disruptive to efficient board operations. Whether the absence is physical or of not being prepared for meetings because the director has failed to read the board materials, the MIA director can drain the productivity of an otherwise effective board. In general, the symptoms of the MIA director include not physically showing up for meetings due to his or her own scheduling conflicts (necessitating calling in to the meetings), paying too much attention to a cell phone or an iPad, and not being able to fully participate in the discussion because the director has failed to read pre-board meeting materials. While these members are not disruptive per se to the quality of a particular discussion within the boardroom or committee setting, their lack of participation is a drain on the overall morale of directors who are present.

The Dinosaur Director

The dinosaur director is a long-standing, experienced director whose day of relevance and ability to add value has passed. The challenge of this director is different in that the director is long serving, was undoubtedly effective in the past, but is no longer able to productively and actively engage in committee and board work. Once a consensus begins to develop that, nostalgia aside, a change must be made, then the challenge of what some call the “empty-seat director” must be addressed.

Boards have too much on their plates to not have every board member fully contributing to the board. In this circumstance, suggesting that the member consider retiring, with full recognition given to his or her contributions, is a thoughtful and effective recourse.

These circumstances require great sensitivity and also much interaction between the CEO and/or the lead director and the director in question.

Dealing with Disruptive Directors

How does a board develop a collective sense that a fellow member is an impediment to the board's progress? The short answer is that it takes time—time for fellow board members to develop a sense that a change is needed, that enough is enough, and that despite all of the individual's experience and wisdom, the group would be better off without the disruptive member's presence on the board.

Usually, the process toward this consensus building begins simply, with one board member asking another if he or she is having similar difficulties with a fellow board member's behavior. As this one-on-one consensus grows, eventually one of the directors reaches out to the nonexecutive chair, lead director, or presiding director to share the group's concerns. It is very likely that the CEO and the lead director may have already discussed their own concerns about the disruptive director.

Remember that an effective board is an essential management tool for the CEO and the CEO's team, so clearly any particularly disruptive director draws attention from the company's most senior levels. For example, after a board meeting, the management team surely will discuss the board meeting, both its positive and negative aspects, with upper management. A disruptive member is a perfectly appropriate topic for discussion with these company leaders.

How Assessments Help

A well-executed annual board assessment will likely reflect any full or brewing discontent concerning a “disruptive director.” If the board uses peer assessments such as those suggested in Chapter 7, “Assessing Board Performance,” the disruptive director situation has an even a better chance of surfacing. Still, even with the most robust assessment practices, the challenge remains that many directors are reluctant to explicitly criticize fellow directors.

End of the Process

As the situation unfolds, the lead director should seek views and opinions from other board members about the putatively “disruptive director.” It takes time to develop a consensus that action is necessary to deal with a disruptive director, but the lead director should have a sense “that the time has arrived.” As we pointed out earlier, boards are a group of peers elected by shareholders, so every effort should be made to communicate concerns and to give the disruptive director an opportunity to change. Nevertheless, sometimes taking action is unavoidable.

As a general practice, most boards include in their governance principles some guidance on director resignations. For example, the Nucor Corporation's “Governance Principles” lists the following guidelines under the headline, “Change in Job Responsibilities”:

> *Directors who have a change or termination in their principal employment or have a substantial change in job responsibilities, in each case other than as a result of a promotion by the director's employer, shall promptly tender their resignation for consideration by the governance and nominating committee. The committee shall evaluate the director's tendered resignation to determine whether it is appropriate for such director to continue on the board in light of the changed circumstances and shall recommend to the board whether to accept or reject such resignation.*[2]

Not all directors accept gracefully the news that their services are no longer required, whether that news is a request for them to resign at the end of their board term or the revelation that their renomination won't be supported by the board. It's not a pleasant time for anyone, and it's one of the more difficult jobs of the lead director, since it is the lead director's responsibility to contact each board member to ensure that a consensus exists to move the disruptive member off the board and to advise the disruptive director that his or her resignation is being acted on and why.

Chapter Summary

This chapter addressed the all too common situation of disruptive directors whose behavior, practices, or style disrupt vital board chemistry and productivity.

Five types of disruptive directors were discussed, including the Dominator, the Micromanager, the Academic, the MIA Director, and the Dinosaur Director, along with techniques to deal with each type.

In general, a consensus to take action regarding a disruptive director takes time to develop and develops from the ground up, beginning with individual discussions between directors. In many cases the CEO is at least aware of a potential issue with a disruptive director through their interactions with the lead director.

What's Next?

Chapter 9, “The Other Succession Challenge—The Board of Directors,” discusses a potential fourth, important focus for corporate boards beyond keeping the right CEO in place, the pursuit of the company's optimal business strategy, and maintaining an up-to-date CEO succession—that is, creating a succession strategy for the board itself.

Notes

[1] Ram Charan, Dennis Carey, and Michael Useem, *Boards That Lead—When to Take Charge, When to Partner and When to Lead* (New York, Harvard Business Review Press, 2014).

[2] Nucor.com. “Governance Principles.” Accessed August 3, 2015, www.nucor.com/governance/principles/index.php?page=6.

CHAPTER 9
THE OTHER SUCCESSION CHALLENGE
THE BOARD OF DIRECTORS

What's in This Chapter?

- Why a Board Needs to Plan for Succession
- Demographics and Board Service Realities
- Enron, the 2008 Financial Collapse, and Dodd-Frank
- Building a Board Succession Plan
- Single-Issue Candidates
- Onboarding a New Director
- The Chemistry Factor
- Chapter Summary and What's Next

We outlined in Chapter 2, “Role of the Board,” the three critical questions that a board must address: (1) Does it have the right chief executive officer (CEO)? (2) Does it have a robust succession process and plan that includes agreement on a short-term successor? (3) Does it have the right strategy, and is that strategy being effectively implemented? This chapter adds an important fourth question: Does it have a succession plan for the board itself?

Why a Board Needs to Plan for Succession

In many ways, a corporate board follows a set of operational principles that mirrors the priorities of the company it serves. In clear terms, high-performing boards have a consistent focus on ensuring that individual members have the relevant skills and experience to meet the current challenges and risks faced by the company.

A February 28, 2015 issue of *IQ Insights* from State Street Global Advisors (SSGA), written by Rakhi Kumar, head of Corporate Governance, addresses this issue directly: “State Street Global Advisors believes that board refreshment and planning for director succession are key functions of the board.” The article goes on to further define the key questions that Kumar believes support effective board director succession practices:

1. Does the board have a process in place that requires it to evaluate its performance and the performance of directors on a periodic basis?
2. Does the board assess the expertise and skills among its directors that are desirable or needed in the context of the company's long-term strategy and risk? (The article suggests an ideal board director experience of one-third new-tenured, one-third mid-tenured and one-third long-tenured. This spread of experience allows the company to leverage the experience and institutional knowledge of longer-tenured directors while limiting the downside risk of short-term director turnover.)
3. Does the company have processes in place that help identify upcoming director turnover.[1]

While these are good overall guidelines for thinking about board succession planning, later in this chapter we will offer a more comprehensive succession grid that is aimed at helping boards carry out this critical selection task. But, for now, let's further consider why having a process in place is more important than ever.

Demographics and Board Service Realities

As we're constantly reminded by the popular press and other media, our life span (and, importantly, our healthy life span) has steadily increased in the past twenty-five years. This demographic reality is reflected in many aspects of our lives, from the boom in senior living communities to the number of products and services aimed at this new class of consumers. Our assumptions about living a long life are also reflected in how we plan for retirement. All financial-planning algorithms now assume a ninety-year (or more) life span. More people than ever above the traditional “retirement age” (sixty-five) are participating in marathons and triathlon races, climbing mountains, trekking through the rain forest, starting new businesses, or engaging in a second career.

This general societal desire to be *more* productive later in life rather than *less* productive has, of course, impacted board service. In fact, according to Spencer Stuart's 2015 Board Index, the average age of a board member since 2004 has moved up from 60.5 years old to 63.1 years old.[2] And that's just an average. As a practical matter, our experience tells us that a typical board is just as likely to have a 70-year-old member as a 60-year-old member. That's because the general assumption is that board members are just as effective at 70 or 75 years old (or older) as they were earlier in their career. You might say that the cliché for board service today is that “70 is the new 60.”

The “official” retirement policy for board members also mirrors this trend. Most of the S&P 500 companies that have established a retirement age (currently about 73 percent of these listed companies) set the official retirement age at seventy-two years of age or older. Thirty percent of this S&P 500 group set the age of retirement at seventy-five years of age or higher.[3]

Enron, the 2008 Financial Collapse, and Dodd-Frank

Another set of factors that impacted board retirement guidelines and succession includes the new, heightened scrutiny of boards, their practices, and the continuing stream of proposed board governance changes and responsibilities. Board experience was invaluable as boards had to deal with the requirements of the New York Stock Exchange (NYSE) listing changes, the Sarbanes-Oxley Act, and the challenges of the 2008 financial collapse, followed by the new demands of the Dodd-Frank legislation, particularly "say on pay."

The practical upshot of these changes to board governance is that the responsibilities workload inside boardrooms has greatly increased. Dodd-Frank legislation has brought its own additional requirements. Boards are now faced with deciding whether and when to act on such things as annual elections and majority vote. Proxies have expanded exponentially with requirements for expanded directors' biographies, including descriptions of what value the directors add to the board, governance practices, whom shareholders should contact on the board if they have questions, the duties of the lead director, and the board process for selecting new directors.

All of these additional duties and responsibilities for board members must be fit within an optimal board size of ten members. In fact, the average size of a board (about 10.8 members) has not changed since 2004, according to Spencer Stuart's 2015 Board Index of the S&P 500 companies.[5]

Importance of Refreshing Board Membership

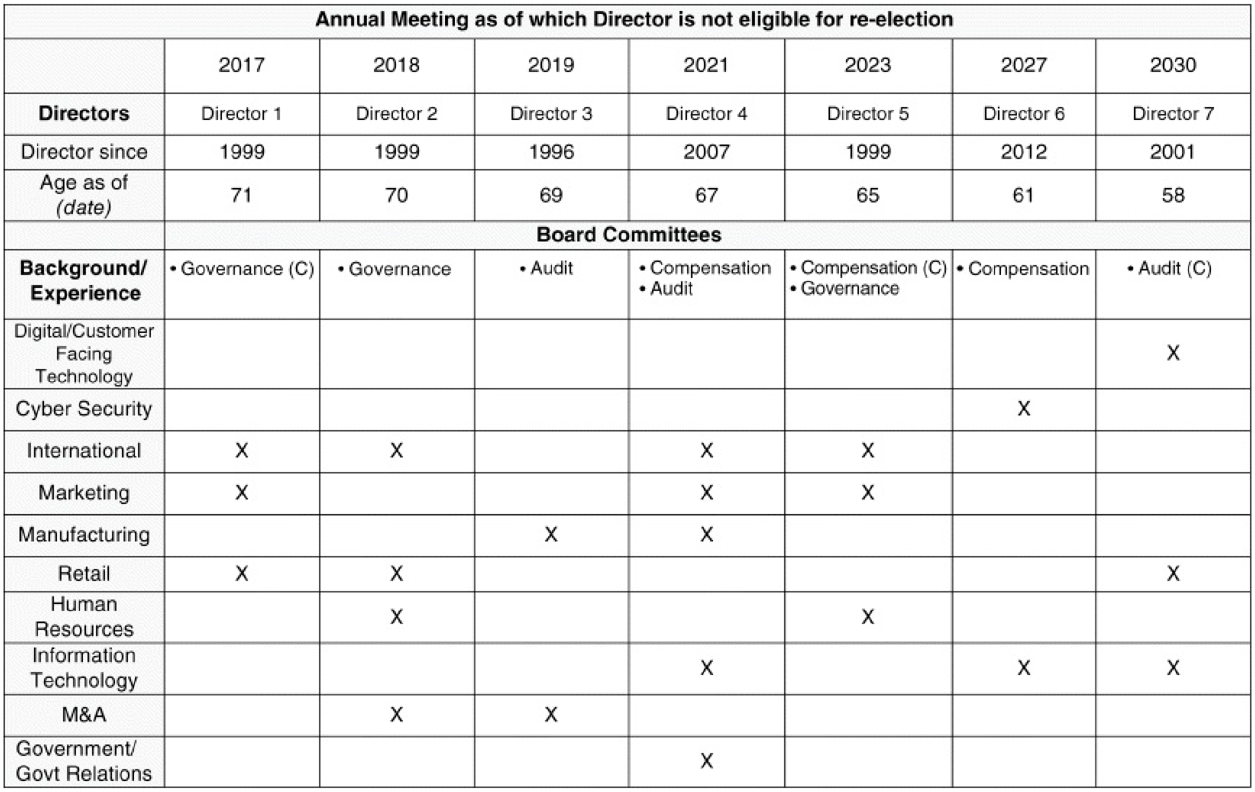
Clearly, shareholders are going beyond interest in the process that boards follow for board member succession to concerns for such issues as tenure, diversity, and quality of board member assessments. BlackRock, the largest manager of securities in the world, offered the following comments in their recently published "Proxy Voting Guidelines for U.S. Securities":[4]

> We encourage boards to routinely refresh their membership to ensure the relevance of the skills, experience and attribute of each director to the work of the board. . . . We encourage boards to disclose these views on: the mix of competencies, experience and other qualities required to effectively oversee and guide management. . . .

As a result, board member compensation has increased to underwrite these new responsibilities. For example, the enhanced audit directive requirements of the Sarbanes-Oxley Act promoted increases in pay for the chair of the audit committee and its members. As other responsibilities were added due to the growing list of statutory requirements, other board committee chairs and committee members began to receive increases in their compensation as well. Today, the average board compensation for S&P 500 companies is $264,000—up 24 percent from 2009 and up considerably more from 2002 compensation levels.[6]

Building a Board Succession Plan

Building a board succession plan requires an organized and consistent approach that considers a wide range of relevant factors, including experience, skills, fitting in with the board culture, and age. We recommend the use of a grid system (see Figure 9.1), which is designed to bring all of these factors into a single, clearly understood visual representation.



	Annual Meeting as of which Director is not eligible for re-election						
	2017	2018	2019	2021	2023	2027	2030
Directors	Director 1	Director 2	Director 3	Director 4	Director 5	Director 6	Director 7
Director since	1999	1999	1996	2007	1999	2012	2001
Age as of *(date)*	71	70	69	67	65	61	58
	Board Committees						
Background/ Experience	• Governance (C)	• Governance	• Audit	• Compensation • Audit	• Compensation (C) • Governance	• Compensation	• Audit (C)
Digital/Customer Facing Technology							X
Cyber Security						X	
International	X	X		X	X		
Marketing	X			X	X		
Manufacturing			X	X			
Retail	X	X					X
Human Resources		X			X		
Information Technology				X		X	X
M&A		X	X				
Government/ Govt Relations				X			

Figure 9.1 Board Succession Planning Matrix

The matrix in Figure 9.1 places members on a horizontal axis according to their chronological age beginning on the left and then moving to the right with the last to retire. The vertical axis lists critical skills that the board feels are important to long-term effective performance. The grid makes it easy to see which members might be retiring next and what skills these members will take with them when they leave. This is such a good tool once completed that it should be included as a standard exhibit in the material for the meeting of the governance and nominating committee. Some companies, such as United Technologies, that choose to create such a grid use the information in their proxies as an illustration of the board's diversity of skills and experience. (See Figure 9.2 for an example.)

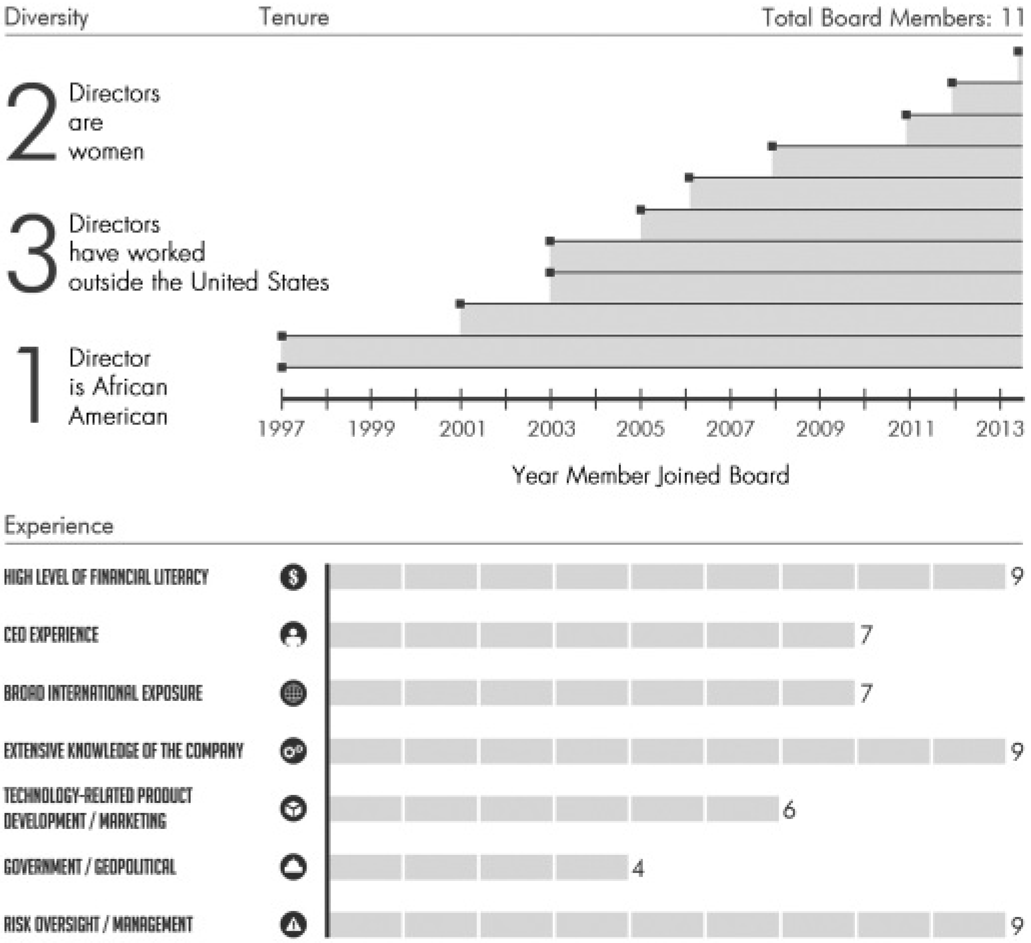


Figure 9.2 The Director Succession Grid

Where to Begin

As suggested by the article by Rakhi Kumar mentioned earlier in the chapter, a reasonable distribution of age and tenure across the board is very desirable. The grid is clearly a useful tool to make this age-range determination easy to visualize and thus to evaluate the loss of important experience and understanding of the company's business, strategy, culture, people, and performance that will be lost with each annual or biannual retirement cycle.

This clear look at the overall makeup of the board should be the starting point for a thoughtful process that allows various committees and the full board to consider what skill set and background would add breadth and depth to the current board's experience and capabilities. This is no small consideration, since you can be sure that shareholders pay attention to this mix. For example, early last year two of Apple's leading shareholders publicly criticized the company because seven of its eight directors were white males over the age of fifty. In response, the company amended its nominating committee charter to demonstrate its commitment to board diversity, subsequently appointing a second female director to fill its next board vacancy.

Board Job Description

Ultimately, the governance and nominating committees and then the board must consider the needed skills for the next director in the form of a “job description” that summarizes the outcome of their considerations. In addition to the raw skills needed, it's important for this process to include the need to create diversity on the board and, importantly, to allow enough time in the process to find qualified candidates. Boards are increasingly concerned with diversity (as they should be), and that has ramped up competition to hire women and people of color with the appropriate background, experience, and qualifications to serve on a board of a publicly traded company.

Single-Issue Board Members

A “single-issue” board candidate is sometimes needed because of an overriding concern or threat to the company, such as data and cyber security, which is an issue that was brought into sharp focus in 2013 and 2014, when cyber criminals hacked into Target and Home Depot customer servers and made off with millions of records containing personal information that could be used to steal the identity of the victims. The threat is so important that the Securities and Exchange Commission (SEC) is asking companies specifically how they plan to address these hacking threats, and Institutional Shareholder Services (ISS) has indicated that it would recommend withholding votes for individual board members, committee chairs, or even the entire board in the event of an obvious failure to address significant risk, such as a major cyber security breach.

It is interesting to note that the January 23, 2015 issue of *Agenda* references a survey conducted by Money-Media, a Financial Times Service Company, which found that 17.7 percent of the respondents said that their boards had enlisted a director with cyber security experience.[7]

Other single-issue candidates might include those with digital retail commerce experience or international candidates, including foreign nationals—that is, individuals from a new or potential market, such as China, India, Brazil, or Russia. Specific industry experience might also be an important selection criterion. For companies working with the federal or military branches of government, it is not unusual for them to seek such background and experience either from the military or someone who has spent considerable time in Washington, DC.

Sometimes this single-issue guidance is specific. For example, after the financial crisis of 2008, activist shareholders pushed for board members with more financial or banking services experience. The 2002 Sarbanes-Oxley legislation noted earlier in this chapter requires that the board designate a financial expert for the audit committee and to certify that the other members of the audit committee are fully qualified to serve on the committee. That's why former or current chief financial officers (CFOs) with an up-to-date understanding of the latest requirements for financial reporting and accounting or retired partners from one of the major public accounting firms are in high demand.

Hire a Consultant?

One option that boards have for seeking advice and guidance in a special area is to hire a consultant on an ongoing basis, especially if the issue is critical to the company, as in the case of cyber security. The preferred option is to hire a full-time consultant, since boards only meet formally four to six times a year and generally over two days, with half of the time taken up in committee meetings. It is possible to bring in a subject matter expert to consult with the members between meetings, but it generally is not nearly as productive or as helpful as hiring a full-time consultant.

The Chemistry Factor

The power of “getting along” (board chemistry), as we discussed earlier in this book, cannot be overemphasized. In fact, it's one of the top items on our list of attributes of board members that creates a highly effective board. As a reminder, these attributes are as follows:

- A group dynamic that balances collegiality with candor.

- A fundamental understanding of the business.
- An appropriate blend of experience, expertise, and wisdom.
- A commitment to invest time and energy into the board and the company.
- A healthy working relationship with the CEO.

The most effective boards develop these attributes, especially the critical component of board chemistry, over time through the often difficult experience of learning the individual styles and personality traits exhibited by the other directors. Building these relationships does pay off. According to a study conducted by Solange Charas, published in the January 9, 2015 issue of the *International Journal of Disclosure and Governance*, “the impact of a board functioning as a team is an eight times greater predictor of corporate performance than individual director's demographics.”[8] The basis for this teamwork is a collaborative and collegial chemistry that must be built over time. The fact is, the potential for an individual candidate to have the ability to be part of this productive board chemistry cannot be gleaned from reviewing a résumé; it takes time and effort to ensure, beyond what's on paper, that bringing the candidate on board will not result in someone who dilutes, if not harms, a high-functioning board.

The Selection Process

Once an agreed-upon job description is developed, the lead director or chair of the governance and nominating committee asks the board members directly if any members have suggestions for candidates either through personal association or through industry sources. Notwithstanding the identification of a strong, agreed-upon candidate, a list of several candidates should be developed, sorted by preference.

Quite often the results of this process are given to a professional search firm. At the upper end of the scale, the fees of these search firms can reach $120,000 to $130,000, so it is not a trivial matter.

If a potential candidate expresses interest and, importantly, indicates that he or she has the time to fulfill the commitments to the board, the director or the chair of the governance and nominating committee—sometimes with, but often without, the CEO—will hold an in-person meeting with the candidate. If the board is relying on its own generated list of candidates, usually the board member who knows the candidate will make the initial contact, but the lead director or the chair of the governance and nominating committee (depending on how the board is organized) instead may make the initial contact.

Next Step

If the candidate has a satisfactory meeting with the lead director or the chair of the governance and nominating committee and spends some constructive time with the CEO, the consideration of a prospective board member's candidacy generally will be taken up at the next board meeting, before any action is taken or further meetings are held.

The best practice is for the candidate to meet with all members of the board, although this is not always possible. Sometimes the candidate just meets with several other board members. In any event, at the conclusion of this due diligence process, the nominating committee and then the full board recommends and votes to elect the new director.

Educating, Onboarding a New Member

The last and critically important step in the selection process is the introduction and education process that follows the new member's election to the board. Boards meet on a limited schedule, so it takes time for a member to develop an understanding of the dynamics of the business and get comfortable with its culture. Learning to work with other board members, let alone building a productive chemistry among other directors, takes time.

In the meantime, it is normal practice for the new director to visit the corporate office alone in order to meet with the members of the management team, including the corporate secretary, general counsel, CFO, and other key corporate players. Depending on the business, new board members should also visit relevant stores, plants, and distribution or IT centers to better understand the business from the ground up.

Chapter Summary

This chapter discussed an added, but all-important fourth question for boards: Does the board have a succession plan for the board itself?

To set this process in place, the chapter offered a comprehensive way for boards to keep succession a key part of their process, along with a useful succession planning grid that tracks each board member's potential retirement for the upcoming ten years. The chapter also discussed “single-issue” board members and how to best utilize their expertise on a board.

Board chemistry and the ability to work as a team is a critical factor in board productivity, and this chapter discussed ways to ensure a collegial and cooperative mind-set on a board.

Finally, the chapter discussed the selection process for nominating and searching for new board members.

What's Next?

Chapter 10, “What's Next in the Boardroom?,” is an honest look at the future of governance, given the influence of recent historical events, societal changes, and legislative and regulatory action, including the 2002 passage of the Sarbanes-Oxley Act and a “game-changing” revision to the NYSE Listed Company Manual that same year. The future of governance practices was also greatly impacted by the 2010 passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act, which was a direct response to the 2008 financial crisis and was designed to improve accountability and transparency in the financial system, and to protect American taxpayers and consumers from both future “too big to fail” bailouts and abusive financial services practices.

Notes

1. Rakhi Kumar, “Addressing the Need for Board Refreshment and Director Succession in Investee Companies,” State Street Global Advisors, *IQ Insights* (February 15, 2015). Accessed August 2, 2015, www.ssga.com/investment-topics/general-investing/2015/Addressing-the-Need-for-Board%20Refreshment-in-Investee-Companies.pdf.

2. 2015 Board Index, Spencer Stuart, Inc. Accessed July 29, 2015, www.spencerstuart.com/ ~/media/PDF%20Files/Research%20and%20Insight%20PDFs/SSBI2014w

3. 2015 Board Index, Spencer Stuart, Inc.

4. 2015 Board Index, Spencer Stuart, Inc.

5. BlackRock. “Proxy Voting Guidelines for U.S. Securities,” February 2015, www.blackrock.com/../en.../blk-responsible-investmnat-guiodelines-us.pdf.

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7. *Agenda*, a Financial Times Service, “Graying of Corporate Boards Continues” (January 23, 2105), www.agendaweek.com/pc/1050203/108163.

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CHAPTER 10
WHAT'S NEXT IN THE BOARDROOM?

What's in This Chapter?

- The Six Biggest Challenges for Boards
- Ongoing Scrutiny of Executive Compensation
- Continuing Demands for More Proxy Information
- More Shareholder and Investor Activism
- Greater Demands for Proxy Access
- Sharper Focus on Risk Management
- Ever-Increasing Scrutiny of Board Composition
- The Way Forward
- Chapter Summary and What's Next

Boards today face unrelenting pressure to provide more information to investors and shareholders. As noted at the beginning of this book, the changes to governance practice over the last sixty-five years have been driven by extraordinary events in the business environment as well as unprecedented upheavals in societal norms and expectations. These economic and societal changes include the following:

- A move away from a manufacturing economy that expanded during World War II and then dominated the world economy throughout the 1950s and 1960s until the beginning of today's service-oriented economy.
- Improvements in the manufacturing process during the 1970s and 1980s, particularly the changes related to the introduction of automation that replaced individual workers.
- The diminishing influence and power of organized labor.
- The “creative destruction” of industry in the 1980s and the new business world that it ushered in, dominated by “corporate raiders” and the use of leveraged buyouts.

- The bursting of the dot-com bubble in 2001.
- The blatant corporate malfeasance that was exposed in 2001 and was exemplified by oil and gas trading giant Enron Corporation, communications giant WorldCom, and home security services company Tyco.
- The huge 2008 financial meltdown and the ensuing economic panic that nearly destroyed worldwide financial and banking systems.

Layered on top of the economic and social consequences resulting from these events are new governmental and regulatory agency rules and guidelines that have been imposed on boards and traditional governance practice. These changes included the following:

- The passage of the Sarbanes-Oxley Act in 2002 (also known as the Corporate and Auditing Accountability and Responsibility Act), which was intended to strengthen the integrity of internal reporting requirements. The law was a direct response to the Enron, WorldCom, and Tyco debacle.
- A 2002 revision to the New York Stock Exchange (NYSE) Listed Company Manual requirements, also in response to the Enron, WorldCom, and Tyco debacle that same year, which strengthened board member independence and voting guidelines; set standing committee minimums (audit, compensation, and governance/nominating); called for annual assessments of the chief operating officer (CEO), the board itself, and each of the three standing committees; and, importantly, set a requirement that the board's independent directors must meet periodically in executive session without company management being present.
- The July 2010 passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (which was a direct response to the 2008 financial crisis), which was designed to improve accountability and transparency in the financial system, and to protect American taxpayers and consumers from both future “too big to fail” bailouts and abusive financial services practices.

As a result of these key historical events and societal, governmental, and regulatory responses to them, the future of governance is likely to be dominated by six key trends in the coming years:

1. Ongoing scrutiny of executive compensation.
2. Continuing demands for more proxy information.
3. More shareholder and investor activism.
4. Greater demands for proxy access.
5. Sharper focus on risk management.
6. Ever-Increasing scrutiny of board composition.

Ongoing Scrutiny of Executive Compensation

Chapter 1, “The Changing World of Board Governance: How We Got Here,” offered a wide-ranging discussion of CEO compensation and the major historical factors that underpin the current discussion of this issue. As we noted, an historic low point in CEO compensation was reached in 1970, when the average wage gap between the CEO and a typical worker was pegged at a factor of only twenty-five. The gap has widened steadily ever since. During the 1980s merger and acquisition frenzy, the wage gap greatly increased, especially in response to that decade's focus on long-term strategic planning that tied ever-increasing compensation packages to targeted CEO performance.

By the late 1980s, the gap was enough of a concern to prompt attempts at federal regulation that was designed to curb CEO wage inflation. One impetus for this regulatory attention was the unintended consequence of urging companies to use stock options in lieu of cash for both short- and long-term compensation, resulting in even wider gaps throughout the 1990s. Throughout the dot-com boom, the wage gap continued to grow so that by 2004 executive pay was on average 104 times that of the average worker, with the top 10 percent of executives earning at least 350 times the pay of an average worker.

Legislative and cascading regulatory responses to Enron, WorldCom, and Tyco's corporate malfeasance in 2002 (the Sarbanes-Oxley Act), and to the high-risk banking practices that resulted in the 2008 worldwide financial crisis (Dodd-Frank Act) have also tried to confront the issue of CEO compensation.

Pressure to Address CEO Pay

The biggest change that has occurred in the last decade as a result of legislative action is the implementation in 2011 of Section 951 of the Dodd-Frank Act, requiring a mechanism to be set up for shareholders to have input into decisions about CEO compensation, known widely as “say on pay.”

Essentially, “say on pay” is a way for shareholders who are unhappy with a CEO's compensation to express their discontent through voting “no” on the appropriateness of how much a company's CEO is being payed. Companies can choose whether to include this “say on pay” option in their proxy material annually, every two years, or every three years. Most companies choose the annual option.

Up until the implementation of Section 951, shareholder resolutions concerning CEO pay had been placed on proxies sporadically, where they garnered limited support. As a matter of reference, in 2006 only five companies received such proxy proposals.

Pay for Performance

The Securities and Exchange Commission (SEC) recently released a “Pay for Performance” disclosure rule (expected to be finalized in late 2015) that will require companies to disclose the relationship between the compensation paid to named executive officers (NEOs) and the financial performance of the company. This information will be included in the Compensation Discussion & Analysis (CD&A) portion of a company's annual proxy and also satisfies a directive of Dodd-Frank.

As a result of these changes, shareholders will have access to a “Five-year Executive Compensation Table” that includes total CEO compensation along with the average compensation of the company's other NEOs. Another table, known as the “Summary Compensation Table,” will set forth total reported yearly CEO and NEO compensation and will include adjustments for equities based on their fair values that vest in the applicable year. The annual change in pension value (based on the actual value of annual service cost) will also be part of the table.

The new SEC rule also requires that companies provide a detailed rationale to support CEO compensation and then correlate that pay level with a peer group's Total Shareholder Return (TSR) and its own cumulative TSR. A multiyear reporting requirement will be phased in in 2016, which will require disclosure of three years of actual paid executive compensation along with this TSR data. Finally, on the horizon is a controversial Dodd-Frank–driven change that is expected to be finalized by the SEC in 2017, which requires a company's proxy to include the ratio of CEO compensation to that of the average company employee.

Continuing Demands for More Proxy Information

Boards are elected to support and work with the management team in order to deliver long-term shareholder value. No two companies in the same industry, let alone in different industries, employ the same metrics to drive their CEO's desired behavior, particularly as it regards the annual bonus plan. The metrics selected by a management team and approved by the board should reflect the metrics that are felt to be most effective in reaching the company's desired strategic objectives. Slowly but surely, policy requirements as described above are forcing every company to include TSR metrics, with the deleterious effect of making it even more difficult for CEOs to employ their own unique philosophy, style, and approach in order to implement their strategy most effectively.

In addition to more data in the CD&A, since 2002 the SEC has required enhanced disclosures for each director through expanded biographies, more detailed explanations that support board membership, and detailed information concerning the other boards that members have served on in the past five years. In addition, there are new required disclosures on board leadership structure.

Responsibilities Detailed

Proxies must now explain why the CEO is also board chairman and provide a detailed accounting of the responsibilities and requirements of the lead director. If the CEO is not the board chairman, then the responsibilities of the nonexecutive chairman must be fully explained. In addition, proxies must include disclosures about the board's role in risk oversight, explanations of the board evaluation process, up-to-date direct contact information for shareholders, an explanation of the nominating process for board directors, stock ownership requirements for directors, and an accounting compensation for board directors.

Since 2012 proxy rules require affirmation and explanation of the independence and compensation levels of committee members. Similar disclosure requirements are in place for the compensation committee advisors. In addition to all of these disclosures, pressure from certain activist shareholders continues for providing clearer, more detailed information and more graphs (particularly around matters relating to pay).

Recently, on July 1, 2015, the SEC published proposed rules for the implementation of Section 944 of Dodd-Frank, which sets requirements for CEO compensation claw-back rules requiring the recovery of excess incentive-based compensation when the company needs to file an accounting restatement. Final action by the SEC on hedging policy disclosures is still pending.

More Shareholder and Investor Activism

Activist shareholder objectives are generally short term, and the actions that they take reflect the current economy and market conditions. For example, in the 1980s, activists either threatened “green mail” or used large amounts of debt in the form of high-yield bonds to effect leveraged buyouts in order to achieve their objectives.

In the 1990s, when stock prices quadrupled, investors of all stripes were more interested in picking winners during the remarkable bull market than challenging boards of directors. Following the dot.com bubble collapse in the late 1990s and as the new millennium unfolded, hedge funds were the activist vehicle of choice to achieve returns well above the market rate. It was a high-returns ride that everyone was happy to join—from large institutional investors to the largest financial institutions and banks—until it all came crashing down in 2008.

As the economy recovered from the 2008 financial crash and resulted in historically low interest rates, activist shareholders, flush with cash from the institutional endowments and pension funds, were now more engaged than ever. As a point of reference, 27 public activist attacks on companies occurred in 2000. In 2014 activists mounted nearly 250 company attacks.

It is important to note that size, level of sophistication, or even performance do not necessarily preclude an activist shareholder publicly attacking a company. Companies such as Apple, Procter & Gamble, Microsoft, PepsiCo, DuPont, and many other well-known companies have experienced the challenge of dealing with activist shareholders' public challenges.

In this environment it behooves any board to take the time to scrutinize the company's performance through the eyes of possible activist shareholders. Activist shareholders' objectives are short term, since they must deliver above-market returns to satisfy their institutional investors. But it does not always make sense to implement or increase a dividend, sell a division, or buy back stock, especially when it means utilizing capital for more strategic, long-term purposes. Certainly, there are underperforming companies in which activist shareholders' demands are well deserved and needed. The challenge is to be sure that your company is not one of them.

In order to answer the challenges proposed by activist shareholders, boards need to be more engaged than ever in the company's strategy and the dynamics of the industry in which they compete, while doing everything possible to compete and outperform their competitors.

Greater Demands for Proxy Access

One of the requirements of Dodd-Frank was more proxy access, which is shorthand for the mechanism that gives shareholders a voice in corporate board elections. It refers specifically to the right of shareholders to place their board director nominees on a company's proxy card if they are dissatisfied with a corporate board. Although the requirement was invalidated by the count in 2011 due to a Chamber of Commerce challenge after being implemented by the SEC, activists continue to propose proxy access for inclusion and a vote in annual proxies.

During 2012 and 2013, only thirty-four shareholder-backed proxy access proposals were included in proxies, with just ten of them receiving the majority support of shareholders. In November 2014 the office of the New York City comptroller launched “the Boardroom Accountability Project” by submitting proxy access proposals for seventy-five companies. These actions were followed by statements from BlackRock, favoring the formula of at least 3 percent of outstanding shares for at least three years for up to 25 percent of the board candidates who are up for election to be placed on the proxy. Vanguard added to the pressure by expressing a preference for a proxy access term of 5 percent per share ownership for at least three years and 20 percent of the board seats. The Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA–CREF), a Fortune 100 financial services organization, advised many companies in which it had investments of TIAA–CREF's preference for the 3–3–25 formula, while Calpers, the California State Teacher's Retirement System (CalSTRS), and Institutional Shareholder Services (ISS) also expressed support for the 3–3–25 formula. Excluding shareholder proposals that were not contested by management and proposals voted on in which the company had always adopted a 3 percent proxy access, there were seventy-five shareholder proposals when votes took place; forty-five proposals received majority support, and thirty did not. The numbers speak for themselves. This is an issue that is gaining momentum; it remains to be seen if it will expand to the extent of being an issue for a majority vote and annual elections.

Marc S. Gerber and Richard J. Grossman of Skadden Arps also reported a significant increase in proposals for proxy access in their June 23 2015 article, “Proxy Access: The 2015 Proxy Season and Beyond.” And there are other signs that the issue of proxy access is still important to activist investors.[1]

Sharper Focus on Risk Management

In 2002 the NYSE dramatically changed its requirements for listed companies. The impact of this change has been noted several times in this book, including the most significant one that requires directors to meet separately from the CEO. However, another 2002 change that required the audit committee to meet periodically to consider and assess risks also has had an enormous impact on governance practice.

The impact has been slow to take effect due to at least two years of debates inside and outside boardrooms about how to implement the requirements. During the balance of the decade leading up to 2008, the practice developed of giving annual presentations to the full board, led by the CEO and the CEO's team, about general risks to the company and how they were being managed.

Today, the ever-popular “heat map” displaying risks by size and likelihood of occurrence is widely employed. In the meantime the audit committee continues to address risks concerning the quality and fidelity of the quarterly and annual financial reports. In addition, some companies, particularly large financial institutions, are addressing this requirement by adding a risk committee or by creating a director position of chief risk officer.

Another risk faced by boards is the potential damage of cyber criminals and the need to address cyber security risks. We discussed the well-publicized customer data security breaches at Target and Home Depot earlier in this book.

In 2011 the SEC issued guidelines regarding public company disclosures of cyber security risks. In fact, this is such an important governance issue that Institutional Shareholder Services (ISS) stated that it will recommend withholding votes against either the specific committee or the entire board in the event of a significant failure of risk oversight. The bottom line is that formal risk management by companies, including understanding and addressing cyber security management, is with us to stay. Boards and their committees ignore the issue at their own peril.

Ever-Increasing Scrutiny of Board Composition

In an effort to influence board composition, certain activist shareholders have begun to focus on the issues of board member tenure, diversity, and mix. ISS has indicated that in cases where the average tenure of all directors exceeds fifteen years, it will scrutinize boards for independence from management and to ensure sufficient turnover in order to allow new perspectives to be added to the boards.

The issue is in its early stage of development, and it remains to be seen whether it will build momentum across a broad cross section of institutional shareholders. BlackRock, in its 2015 Proxy Voting Guidelines for U.S. Securities, devoted a separate section to this issue. The particular issue was that of boards seriously considering their responsibility for refreshing the membership of their boards.

Adding to the chorus, as reported in the July 10, 2015 issue of *Agenda*, in an article titled “Calpers Cautions on Composition Policy,”[2] CalSTRS also released a publication emphasizing its position on board composition.

It behooves the governance and nominating committees, as well as entire boards, to engage in discussion and consideration of the topic, as the issue requires the full board's engagement. No one should overreact, but on the other hand, board members should be aware of the issue and, as openings occur on the board and are filled, understand that scrutiny will follow.

The Way Forward

As we've outlined throughout this book, the challenges that boards face today are directly connected to relatively recent, large-scale economic and social upheavals that have driven increased restrictive federal and regulatory agency rules and guidelines, and more shareholder scrutiny and activism. We've also noted that some of these changes have a definite political, environmental, or socially focused agenda behind them, including these examples:

- Individual investors, sometimes called “corporate gadflies,” who repeatedly file common shareholder proposals at multiple companies.
- Institutional investors with a “social investing” purpose or who are affiliated with a religious group, charitable organization, or public-policy organization.
- Pension funds—chiefly state or municipal public funds or private “multi-employee” funds (e.g., labor unions)—whose representatives advocate for their cause.

The bottom line is that efforts to influence boards and their companies will continue, and in response the SEC is likely to continue to promulgate new requirements.

Of course, what hasn't changed, no matter what the future holds, is the board's fiduciary duties to deliver long-term sustainable value to shareholders. In order to do so, boards need to continue to find ways to constructively, thoughtfully, and legally comply with new regulations and to do what is necessary to address any issues without compromising their ability to spend sufficient time answering the three most important questions that every board must answer:

- Do we have the right CEO?
- Do we have a current, agreed-upon succession plan in place?
- Do we have the right strategy, and is it being effectively implemented?

Chapter Summary

The future of governance is likely to be dominated by six key trends that include ongoing scrutiny of executive compensation, continuing demands for more proxy information, more shareholder activism, greater demand for proxy access, a sharper focus on risk management, and ever-increasing scrutiny of board composition.

These trends are the result of historical events and societal changes, and the unique set of governmental and regulatory responses that were offered in response to them. Focus on executive compensation grew more intense as the wage gap between CEOs and the average worker steadily widened through the 1980s and 1990s, and was exacerbated by the Enron, WorldCom, and Tyco corporate malfeasance scandal in 2002 and the worldwide financial crisis in 2008.

Increasing demands for more proxy information also have been driven in part by these same historical events, since shareholders and investors are more interested than ever in assurances that boards are keeping their fiduciary and governance commitments to company shareholders and stakeholders. This accountability extends to the imposition of some very direct responses to keep boards in line and even includes the potential “claw back” of excess incentive-based compensation given to top company executives. Boards must be more engaged than ever in the company's strategy and the dynamics of the industry in which they compete to understand and respond appropriately to these demands.

Finally, in the coming years boards will see a greater focus on managing both potential financial risk to their company and the external threats posed by cyber criminals. These are such important issues that ISS has stated that it will recommend withholding votes against either the specific committee or the entire board in the event of a significant failure of risk oversight.

What's Next?

The Appendix section of this book contains a host of practical worksheets and assessments that will help the reader implement the recommendations made in this book in order to improve both board governance and productivity.

Notes

[1] Marc S. Gerber and Richard J. Grossman, “Proxy Access: The 2015 Proxy Season and Beyond,” June 23, 2015.,Accessed July 31, 2015, www.skadden.com/insights/proxy-access-2015-proxy-season-and-beyond.

[2] Agenda, A *Financial Times* Serice, “Calpers Cautions on Composition Policy” (July 10, 2015), p 16.