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THE TEXTURE OF LOYALTY

By

Deborah A. DeMott*

I. INTRODUCTION

This paper examines whether and how reforms in corporate governance practices may reshape conventional notions of fiduciary duty in the corporate context. The paper focuses on public corporations and on duties owed by non-executive directors, those directors who are not also officers or employees of the corporation. Although most of the paper addresses developments in the United States, the underlying issues may hold more general interest.

I identify two focal points for the evolution of directors’ fiduciary duties. First, various reforms in corporate governance assign specific responsibilities to directors, arguably reorienting directors’ loyalty to due discharge of a specified function along with ongoing or residual duties of loyalty owed in more general terms to the interests of the corporation and its shareholders. The relationships between these specific duties and more general ones may be complex, as may be the consequences of increased emphasis on work to be done by directors as members of committees in contrast to the board as a whole. In particular, governance reforms situate directors who serve as members of audit committees as essential links between the corporation and the integrity of gatekeeping functions performed by its external auditors. In fulfilling their

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duties, audit committee members serve public-regarding or systemic interests beyond those of the corporation’s present shareholders.

Second, reforms in corporate governance practices imply that a director’s duty of loyalty to the corporation and its shareholders requires more than disinterest, narrowly defined. That is, a director’s duty of fidelity to the interests of the corporation imposes more than an obligation to refrain from participating in board decisions in which the director has an undisclosed and material financial or other economic interest. Reforms in corporate governance require conceptualizing a director’s duty of loyalty in more active or affirmative terms that incorporate some degree of diligence and also require a broader understanding of circumstances that may compromise a director’s ability to bring independent judgment to bear. How the duty is defined and what consequences follow upon breach are questions that matter much more than whether the duty should be termed one of “loyalty” as opposed to “care” or “good faith.”

The paper prefaces discussion of the evolution of directors’ duties by posing two more fundamental questions about contemporary corporate governance: what role precisely should be assigned to directors, distinct from a corporation’s officers and its other senior executives? And what implications should follow for the powers of shareholders? To the extent that directors can reasonably be expected to serve only a relatively formal or vestigial function, an expansion in shareholders’ powers may be justified. On the other hand, heightened expectations of performance by directors may require close attention to how boards are structured and may call into question the justifications offered for further empowerment of shareholders.

II. ARE DIRECTORS VESTIGIAL?
Recent scholarship on corporate governance questions calls into question whether it is realistic to expect that most directors of public U.S. corporations have either the capacity or the sustained will to discharge functions that require the exercise of judgment independent of senior management. As components of corporate governance, directors may be viewed by some as vestigial appendages who are formally necessary but not functionally significant. Although I believe this perspective is excessively pessimistic, engagement with it is essential in considering how directors’ duties may evolve. Governance reforms emphasize increasing the proportion of directors who are independent of corporate management, using various formal definitions of independence. But if it is unlikely that independent directors will in fact bring independent judgment to bear as members of the board, this pattern of reform is likely to prove unsatisfactory.\footnote{A gentler characterization of the recent situation is that “[d]irector fears of personal liability and reputational risk have increased dramatically as the regulators and the courts seek to change the role of the board from resource to oversight.” Robert E. Bostrom, Corporate governance: developments and practices one year after Sarbanes-Oxley, \textit{Corporate Governance} 2003, \textit{at} 189, 192 \textit{Int’l Fin. L. Rev.} (2003).}

Consider the assessment of directors’ capacity for independent action in the recent work of Professors Lucian Bebchuk and Jesse Fried. In their book, \textit{Pay Without Performance}, Professors Bebchuk and Fried focus on how senior officers – principally CEOs – assert dominant influence over the terms and amount of their own compensation despite the formal allocation of power over compensation to compensation committees of boards.\footnote{Lucian Bebchuk & Jesse Fried, \textit{Pay Without Performance: The Unfulfilled Promise of Executive Compensation} (2004).} The underlying explanation, in the authors’ assessment, is that directors depend on the CEO for their initial selection as
directors and their continued presence on the board, as well as for their compensation for service as directors.\(^3\) As a consequence, directors do not occupy a stance of arms’-s-length negotiation with either the corporation’s incumbent CEO or with his or her successor, given directors’ incentives to establish a collegial relationship with a new CEO.\(^4\)

Moreover, Bebchuk and Fried are not sanguine about the likely impact on executive compensation practices of reforms that focus on directors’ independence. Independent directors are likely to lack an ownership stake in a corporation that is sufficient to furnish “affirmative incentives” to enhance shareholder value and offset any residual tendency to accede to compensation packages that favor executives.\(^5\) Their continued tenure as directors depends in large measure on remaining in the good graces of the CEO and their other colleagues on the board.\(^6\) What’s needed, in Bebchuk and Fried’s assessment, is to “increase the power of shareholders vis-à-vis directors...[to] make directors not only more independent of executives but also less independent of shareholders.”\(^7\) They recommend enhancing shareholders’ powers to remove directors, to propose candidates for the board, and to make mid-stream amendments to

\(^3\)Id. at 26-30.

\(^4\)Id. at 40, 84-85.

\(^5\)Id. at 203. This is so even though reforms impose additional requirements for compensation committees: “[w]hile procedural requirements may mitigate problems arising from carelessness and insufficient attention...they do not address those arising from directors’ incentives and tendencies to use their discretion in ways that favor executives....With the help of lawyers and compensation consultants, directors who wish to favor executives will usually be able to offer justifications for their choices....” Id. at 195.

\(^6\)Id. (“[t]he CEO and his or her director allies may not fully control board nominations in the future, but remaining on good terms with them is likely to continue to increase a director’s chances of being renominated.”).

\(^7\)Id. at 207.
the corporation’s charter.8

As it happens, the degree to which directors are relatively “independent of shareholders” in public U.S. corporations is striking to overseas observers. For example, under the Delaware corporation statute, a majority of shares lacks power to remove a corporation’s directors without cause if the directors’ terms are staggered, unless the corporation’s certificate of incorporation provides otherwise.9 Shareholders who wish to change the composition of a corporation’s board must await the annual meeting at which directors stand for election, a waiting process that extends across multiple meetings when directors’ terms are staggered. To change the composition of the incumbent board at the annual meeting requires nominating alternative candidates and then bearing the costs of soliciting sufficient shares to vote in favor of their election, a complicated and expensive process. In contrast, section 303 of the U.K’s Companies Act of 1985 permits an ordinary majority of shares at any time to dismiss some or all directors. The impact of section 303 is enhanced by section 368, which enables 10% of the shares to requisition a shareholder meeting.10 In U.K. corporations, directors’ tenure in office is thus

8Id. at 208-213. Outside the compensation context, Professor Bebchuk has also written in support of allocating power to shareholders over basic governance structures. See Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 833 (2005).

9Del. Code Ann., tit. 8, § 141(k)(i). Delaware is significant as the site of incorporation of many large public companies and as the jurisdiction with the fullest-developed body of cases interpreting both its corporation statute and non-statutory doctrines.

10For fuller development of these contrasts, see Paul Davies, SHAREHOLDER VALUE, COMPANY LAW, AND SECURITIES MARKETS LAW: A BRITISH VIEW, in CAPITAL MARKETS AND COMPANY LAW 261, 265-266 (Klaus J. Hopt & Eddy Wymeersch, eds. 2003). Under the Delaware statute, the power to call special meetings of shareholders is a power held by the board of directors or by “such person or persons as may be authorized by the certificate of incorporation or by the by-laws.” Del. Code Ann., tit. 8, § 211 (d). Unless a corporation’s certificate of incorporation provides otherwise, a shareholders may take action without a meeting through the mechanism of a written consent signed by “the holders of the outstanding stock
always more vulnerable to intervention by shareholders.

That directors of U.S. public companies are relatively less vulnerable to shareholder intervention may be defensible. Placed in broader perspective, directors’ relative independence from shareholders may be justified as a mechanism that responds to tensions implicit within or engendered by the corporate form that are distinct from tensions or conflicts between shareholders and managers. Thus, conferring discretion on directors to make decisions independent of the manifest will of holder of a majority of shares can be defended as a mechanism to mitigate intra-shareholder conflict or to reduce opportunistic conduct by shareholders toward employees. And, as discussed below, a measure of independence from shareholders may be crucial to the extent that directors serve functions defined by systemic interests that differ from the interests of its present shareholders.

However formulated, any justification of directors’ independence from shareholders requires some degree of confidence that a sufficient number of directors will in fact exercise independent judgment. No one factor operating in isolation assures that such confidence will be warranted. A complex of factors – among them individual directors’ risks of legal liability and public embarrassment, their individual sense of responsibility, formal board structures and procedures, interpersonal dynamics – all make demonstrable contributions to the diligence with which boards discharge their responsibilities. Such factors in combination may assure that

having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted....” Id. § 228 (a).

directors have sufficient resolve to discharge their duties responsibly, even those directors who do not individually hold large ownership stakes in a corporation.\textsuperscript{12}

It is also significant that directors and boards do not operate in a temporal vacuum. Scandals and systemic crises of confidence that prompt reform also shape how directors understand and perform their duties and how they interact with the corporation’s senior officers. In particular, patterns of deference and acquiescence, previously unexamined, may no longer feel comfortable.\textsuperscript{13} Patterns of interaction change when the consequences of newly-felt discomfort

\textsuperscript{12}However, in the executive compensation context scrutinized by Bebchuk and Fried, there is a demonstrable connection between directors’ equity stakes and CEO compensation: corporations in which members of the compensation committee hold large amounts of stock pay their CEO less. See Bebchuk & Fried, \textit{supra} note 2, at 35 (reporting finding by Richard M. Cyert, Sok-Hyon Kang & Praveen Kumar, \textit{Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence}, 48 \textit{Management Science} 453-469 (2002).

The context at issue in this paper is broader, however. In particular, although executive compensation questions are important, directors serve functions – other than approving or structuring executive compensation packages – that are more important in crucial respects. These include oversight of the integrity of the corporation’s financial reporting and its compliance with the law. Moreover, although the decisions that directors make to hire and fire members of senior management, including the CEO, are related to decisions about compensation, they carry consequences independent of compensation decisions. In particular, the corporation and its shareholders may lose more as a consequence of management decisions made by a CEO – whether erroneously chosen in the first place or overdue for removal from office – than the amounts lost through excessive pay. To be sure, how compensation packages are structured may shape CEOs’ incentives in benign or perverse ways from the standpoint of concerns with legal compliance and integrity in financial reporting. See Bebchuk & Fried, \textit{supra} note 2, at 10, 162-164, 183-185. Compensation structures, however, are not the sole mechanism available to induce managerial behavior responsive to such concerns.

\textsuperscript{13}The relative importance of the CEO in U.S. corporations has not escaped notice by overseas observers. Jonathan Rickford writes that “[t]o generalize dangerously, to British eyes the U.S. business philosophy tends to place much more emphasis on the charismatic business leader, highly remunerated, highly professional, trained in the intellectual ferment of the business school, relied upon to deliver the success of the capitalist system.” Jonathan Rickford, \textit{Do Good Governance Recommendations Change the Rules for the Board of Directors}, in \textit{Capital Markets and Company Law}, \textit{supra} note 9, at 461, 474. Thus, Mr. Rickford concludes, “[w]hile the focus in the U.K. has been on attracting capital, the focus in the U.S. has
extend beyond an environment of immediate crisis and threat. An indication that old patterns no longer hold is the noticeable recent increase in forced resignations of CEOs.

III. DIRECTORS’ DUTIES REFOCUSED

A. From Generality to Specificity: Content and Structure

In large companies, it has long been unrealistic to cast the board of directors in a role of detailed operational management. The contemporary understanding is that a board takes action on matters that the company’s organizational documents or the law specifically charge to it, as well as appointing the company’s officers. Indeed, selecting and appointing a CEO, vetting the terms of the CEO’s compensation, and determining whether an incumbent CEO’s tenure in office should be ended are among a board’s basic responsibilities. It’s also well understood that contemporary boards discharge many functions through committees, often through a process of formal delegation from the entire board that in reality reflects substantial deference to the

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14 Compare Bostrom, supra note 1, at 189 (“[a] year ago, the events leading up to the enactment of Sarbanes-Oxley made it clear that traditional corporate governance structures and risk management systems did not address the challenges faced by companies and boards of directors....Although there has been much rhetoric about corporate governance reform, the underlying reality is that changes in culture and values have been slow in coming. The response of management and boards has been slow – evolutionary at best, but certainly not revolutionary.”) with Alexi Barrioneuvo, The Rise of the Boards: As Directors Feel Their Oats, Chiefs Are Put Out to Pasture, N.Y. TIMES, Mar. 15, 2005, at C1, C8 (Arthur Levitt, Jr., former chair of SEC, states that “‘[t]he fraternal culture that characterized America’s boards is undergoing a dramatic change to a culture of skepticism....The humility and embarrassment of the past few years, combined with regulation, have changed the culture of boardrooms.’”).

15 See Barrioneuvo, supra note 14, at C8 (reporting record number of changes in chief executives to date in 2005).

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A basic question is whether the entire board must act on a matter or whether action by a committee will suffice. Under Delaware law, for corporations organized after July 1, 1996, only the board may act to adopt, amend, or repeal by-laws; and only the board may act on matters required by statute to be submitted to shareholders for a vote, such as the approval of a merger agreement. See Del. Code Ann., tit. 8, § 141 (c)(2). For previously-organized corporations, action may be taken by a committee of the board on certain matters, such as the declaration of a dividend, if so authorized in the corporation’s certificate of incorporation. See id. § 141 (c)(1).

This is consistent with the statutory prescription that “[t]he business and affairs of every corporation...shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.” Id. § 141 (a).

See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02, Comment d (“oversight” function of board “is usually performed, not directly by actively supervising the principal senior executives, but indirectly by evaluating the performance of those executives and replacing any who are not meeting reasonable expectations concerning job performance.”).

Phrased a bit differently, “[t]he board’s obligation to oversee the performance of the principal senior executives does not imply an antagonistic relationship...Rather, it contemplates a collegial relationship that is supportive as well as watchful.” Id.
with each other. Vigilance often requires that a director keep some distance from senior management, perhaps adopting an attitude toward senior management that, if not skeptical, is less than acquiescent. However, directors’ vigilance may be inhibited to the extent that directors bond with senior management, for example by helping to shape management’s strategic vision for the corporation.

Recent governance reforms articulate aspects of directors’ duties with greater specificity and require that some duties be discharged through committees comprised entirely or predominantly of independent directors. Thus, such reforms focus on the content of directors’ duties as well as the corporate governance structures through which the duty may be fulfilled.

A few general questions about these reforms are worth bearing in mind. First, a board’s success requires that the board be capable of operating as a body, not simply an aggregation of individuals who satisfy various formal criteria definitive of independence. The emphasis in recent reforms on directors’ independence may overlook significant aspects of board operation. Directors who are executives or officers may be valuable contributors to boards, at times because they may contribute a managerial presence that counter-balances the CEO’s influence and widens the flow of information from within the company to the board as a whole. Requiring that functions be discharged by independent directors, or by committees comprised entirely or in large measure by independent directors, may as a practical matter crowd out the boardroom presence of officer-directors other than the CEO, thereby strengthening the CEO’s hand in relationships with the board. This may be especially likely in corporations that follow the so-far-traditional U.S. pattern of dual service of the CEO as the board’s chairperson. Likewise, the emphasis placed by recent reforms on duties to be discharged by committees may undercut the
board’s ability to function cohesively as a body. Other structural reforms may serve to allay some of these concerns, for example requiring the appointment of a lead director from among the board’s independent members when the CEO also serves as chairman, as well as requiring regular meetings of the board’s independent members outside the presence of the CEO. These measures should reinforce the capacity of independent directors to act cohesively and reflectively as a distinct group within a corporation’s governance structure.20

B. Audit Committees

Audit committees are exemplars of recent reforms in the content of directors’ duties and in the internal governance structures through which directors discharge their duties. Moreover, governance reforms assign to audit committees an essential linkage function with external auditors, thereby internalizing into the corporation’s internal governance a mechanism that furthers systemic interests in the integrity of gatekeeping functions served by external auditors. Audit committees’ linkage function justifies independence requirements for their members that reflect criteria distinct from alignment with the interests of the company’s present shareholders.

1. Audit Committee Functions and Members’ Orientation. — Sarbanes-Oxley (“SOX”) confers specific mandates on the audit committees of the companies to which it applies.21 SOX

20For development of this point, see Jennifer Hill, Corporate Scandals Across the Globe: Regulating the Role of the Director, in Reforming Company and Takeover Law in Europe (Guido Ferrarini et al., eds. 2004).

21SOX’s mandates have parallels in other jurisdictions. For example, the U.K’s Combined Code on Corporate Governance requires that a board establish an audit committee with delineated responsibilities, including monitoring “the integrity of the financial statements of the company’ and making recommendations to the board for shareholder approval in general meeting relating to the “appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor.” Combined Code on Corporate Governance §C3 (2003)[hereinafter Combined Code]. The Combined Code also

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section 301(2) provides that an audit committee shall have direct responsibility for the appointment, compensation, and retention of any accounting firm employed “for the purpose of preparing or issuing an audit report or related work.” Such an accounting firm “shall report directly to the audit committee,” and the committee’s oversight responsibility encompasses “resolution of disagreements between management and the auditor regarding financial reporting.” To carry out its duties, an audit committee has authority under SOX section 301(5) “to engage independent counsel and other advisers” as the committee determines necessary. SOX additionally imposes obligations on auditors that further define their

In contrast with SOX, the U.K. and Australian provisions are formally cast as recommendations, not legal mandates. However, non-compliance requires disclosure and explanation. See Combined Code at Preamble ¶ 5 (“While it is expected that listed companies will comply with the Code’s provisions most of the time, it is recognized that departure from the provisions of the Code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions.”); ASX Recommendations at 5 (“[t]he best practice recommendations are not prescriptions. They are guidelines....”) The ASX’s listing requirements require that companies provide “a statement in their annual report disclosing the extent to which they have followed these...recommendations....Where companies have not followed all the recommendations, they must identify the recommendations that have not been followed and give reasons for not following them.” Id.


Id.

Id. § 10A(m)(5); 15 U.S.C. § 78f(m)(5).
relationship to the audit committee. Under SOX section 204, an auditor has a duty to make timely reports to the audit committee of “all critical accounting policies and practices to be used,” alternative treatments of material items discussed with management, and “other material communications” between the auditor and management.\textsuperscript{25} The relationships that SOX mandates between an auditor and the audit committee are buttressed by its additional requirement that the SEC require by rule that a company’s principal executive officers and chief financial officer certify that they have disclosed to the auditor and the audit committee the results of their most recent evaluation of the company’s internal controls, including corrective actions taken to address significant deficiencies and material weaknesses.\textsuperscript{26}

This specification of function is likely to have an impact on the orientation of members of audit committees. They remain directors of the corporation, subject to the general fiduciary duties owed by any director. However, their membership on the audit committee additionally situates them as the internal fulcrum of relationships between the corporation’s management and its external auditor, whose commitment should be toward a systemic or public-regarding orientation.

As a consequence, an audit committee’s orientation may mirror in key respects that required by the auditor’s role. That role is not simply one of an agent who acts on behalf of a client as a principal. Thus, characterizing the auditor’s role through the lens of a simple principal-agent relationship misunderstands the role.\textsuperscript{27} An auditor’s professional norms and legal


\textsuperscript{26}SOX § 302(a)(5); Exchange Act Rule 13a-14(5).

\textsuperscript{27}See William W. Bratton, \textit{Shareholder Value and Auditor Independence}, 53 DUKE L. J. 439 (2003). For a contrasting view, see Lawrence E. Mitchell, \textit{The Sarbanes-Oxley Act and the...
duties are centered on assuring integrity in financial reporting, not on loyal service to the manifest wishes of a particular client. An auditor’s professional role also gives the auditor a systemic interest in setting rules and standards going forward that presupposes independence from the manifest wishes of any given client.

Moreover, the principal-agent characterization of an auditor’s role becomes no more persuasive if the auditor’s “principal” is defined to be the client’s shareholders. Pursuing the requisite integrity in a particular audit engagement may not always be consistent with the wishes of all of the company’s current shareholders, some of whom may favor appropriately aggressive accounting choices. Indeed, some shareholders may be indifferent to the risk of outright fraud on the assumption that their particular position will enable them to sell in advance of full market corrections. More benignly, substantial shareholders – including those with good access to a company’s senior management – may simply not press for answers when management’s story has become increasingly implausible\textsuperscript{28} and may not favor more rigorous accounting or audit practices, preferring instead to act consistently with belief in management’s

\textit{Reinvention of Corporate Governance}, 48 Vill. L. Rev. 1189, 1198 (2003)(characterizing SOX reforms as “connect[ing] auditors with the board and management in a way that brings them inside the corporate box”).

\textsuperscript{28}See William W. Bratton, \textit{Enron and the Dark Side of Shareholder Value}, 76 Tulane L. Rev. 1275, 1339 (2002)(reporting that behavior of at least two holders of significantly-sized blocks of Enron’s stock implies “that these investment institutions, despite their significant stakes, acted out the archetype of the noise trader, investing on market hyperbole rather than fundamental value. Such investment value is driven by cognitive bias rather than by expert monitoring….some seem to have held on even as the handwriting was on the wall, subjectively assessing the situation by their own sunk costs.”). To be sure, some sophisticated investors employ trading strategies that enable them to profit amidst mass folly. For an early example, see Peter Temin & Hans-Joachim Voth, \textit{Riding the South Sea Bubble}, 94 Am. Econ. Rev. 1654 (2004).
B. Requiring Independence Beyond Independence from Management. — General definitions of independence for directors focus on criteria indicative of a director’s independence from the company’s management. Both the NYSE and Nasdaq require that independent directors comprise a majority of the board. Both also require that the board make an affirmative determination of whether each of its members is independent, applying specified criteria that begin, in the NYSE’s formulation, on whether the director has a material relationship with the corporation, or in Nasdaq’s formulation, on whether the director has a relationship with the company that would interfere with the exercise of responsible judgment in carrying out a director’s responsibilities. More specific indicia include an employment relationship, a non-employment relationship under which the director or an affiliate has received substantial payments from the corporation, a family relationship with an executive officer of the corporation, or service as an executive officer of another entity with which the corporation has an economically material relationship.

29 NYSE CORPORATE GOVERNANCE RULES, Rule 1 (hereinafter NYSE CORPORATE GOVERNANCE RULES); NASDAQ Rule 4350(c)(1).

30 NYSE CORPORATE GOVERNANCE RULES, Rule 2(a); Nasdaq Rule 4200.

31 Under the NYSE’s criteria, a director is independent only if the director has none of these relationships: (1) employment by the company; (2) a family member of an executive officer; (3) recipient or immediate family member of recipient of more that $100,000 in compensation from company, other than compensation for service as a director or pension or deferred compensation for prior service; (4) affiliation with, or employment by, or immediate family member of person who is affiliated with or employed in a professional capacity by a present or former internal or external auditor of company; (5) participant or immediate family member of participant in an interlocking compensation arrangement; and (6) executive officer or employee of, or immediate family member of executive officer, of company that makes or receives payment for goods or services from company in an amount that in a single fiscal year exceeds the greater of 2% of other company’s gross consolidated revenues or $1 million.
In contrast, SOX section 301(3) focuses exclusively on independence of members of audit committees, requiring that each member of a public company’s audit committee be independent. As defined in section 301(3)(B), independence for audit committee purposes has two components: (1) a director may not accept any direct or indirect consulting, advisory, or other compensatory fees from the company other than fees for service as a director or member of the audit or other committee; and (2) a director may not be “affiliated” with the company or any of its subsidiaries. The SEC defines a person as a company’s “affiliate” or “affiliated person” if the person controls the company, is controlled by it, or is under common control with it. However, a person is not deemed to control a company if the person is not the direct or indirect beneficial owner of more than 10% of any class of voting equity securities of the company or an executive officer of such a beneficial owner. Thus, a 10% equity ownership threshold


\[\text{\textsuperscript{34}}\] Exchange Act Rule 10A-3(e)(1)(i).

effectively bars the door to audit committee service by such owners and their executive officers. 36

Defining independence so as to exclude substantial shareholders from membership on audit committees has been criticized as ignoring the alignment between a director’s economic interests and the fortunes of the company. 37 Indeed, both the NYSE and Nasdaq chose affirmatively to characterize shareownership as a relationship that does not preclude a determination that a director is independent. 38 However, it is important to be mindful of the

36 This bar has counterparts in other jurisdictions. In the U.K., the Combined Code requires that all members of an audit committee be independent non-executive directors. Representation of a “significant shareholder” and receipt of remuneration from the company are factor that, when present, requires the board to state its reasons for determining that the director is nonetheless independent. See COMBINED CODE, supra note 21, at § A.3.1. In Australia, the ASX Recommendations provide that a board should establish an audit committee consisting solely of non-executive directors, a majority of whom are independent directors. See ASX Recommendations, supra note 21, Recommendation 4.2. Under Recommendation 2.1, an independent director is a non-executive director who is “independent of management and free of any other business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the exercise of their independent judgment.” Id. Substantial shareholding as defined in the Corporations Act is specified as such a relationship. Id. If a director is a substantial shareholder or is associated with a substantial shareholder, the board must state its reasons for concluding that the director is nonetheless independent. Under the Corporations Act § 9, a person has a substantial shareholding in a body corporate if “(a) the total votes attached to voting shares in the body...in which they or their associates: (I) have relevant interests...is 5% or more of the total number of votes attached to voting shares in the body....”


38 In the NYSE’s formulation, “as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.” NYSE CORPORATE GOVERNANCE RULES, supra note 29, Commentary to Rule 2(a). Likewise, “[b]ecause Nasdaq does not believe that ownership of company stock by itself would preclude a finding of independence, it is not included in the aforementioned objective factors” with which to assess independence. See SEC Release No. 34-47645 (Nov. 3, 2003)(approving corporate governance standards filed by NYSE and Nasdaq).
specific set of functions that contemporary audit committees must perform. As noted above, an audit committee is an essential link between a company and the functions performed by its external auditor. The systemic interests served by auditors are not necessarily coincident with the interests of a client’s shareholders. Shareholders’ preferences on accounting choices are neither uniform nor stable, nor are shareholders uniform in investment objectives or whether they have other ties to a company and its management. Thus, the disqualification of substantial shareholders may reflect a concern for the appearance, if not always the reality, of interests and power that do not typify a company’s shareholders as a group. The categorical way in which SOX expresses the disqualification may reflect the practical value of distinguishing among relationships that share common objective traits but may well differ in reality.

39See Bratton, supra note 27, at 472.

40For example, venture capital firms are distinctive, if not unique, as shareholders in marrying their investment in shares – or in securities convertible into shares – with relatively specific plans to dispose of shares through initial public offerings and post-IPO secondary offerings, as well as with a range of structures to assure that a portfolio company’s senior management heeds the interests of its venture capital investor. These include employment agreements with senior management and voting trusts and other agreements that give the venture capital firm authority to vote shares owned by members of senior management.

41This analysis is not inconsistent with acknowledging the value of independent directors’ individual investment in shares of companies on whose boards they serve. A study published in 2000, based on samples of public companies in the United States, compared 40 companies that had out-performed their peers between 1987 and 1996 with 40 laggards. In the better-performing companies, outside directors each owned an average of $470,000 of the company’s shares; in the lagging companies, outside directors each owned an average of $80,000 in the company’s shares. See Donald Hambrick & Eric Jackson, Outside Directors with a Stake: The Linchpin In Improving Governance, 42 CAL. MGMT. REV. 108 (2000). At the time, relatively few companies had share-ownership programs for outside directors, which suggests that the directors purchased their shares out of personal funds. Although such an investment may be material to an individual director, and could well have the salutary consequence of heightening the director’s diligence, the magnitude of such an investment would be well below the threshold for disqualification under SOX § 301.
The mandates conferred on audit committees arguably shift their focus away from an orientation defined almost exclusively by the interests of the company’s shareholders and toward the public-regarding orientation of external auditors, whose professional norms and legal duties are centered on assuring integrity in financial reporting. If so, it comes as no surprise that rules regarding the composition of audit committees depart as well from focusing solely on independence of directors from a company’s management, possibly reflecting a concern that some of a company’s present shareholders might be less than unswervingly keen that the company’s financial results be fairly presented.

C. A Template for Further Development?

It’s an open question whether contemporary norms of corporate governance will evolve further in the direction of casting all independent directors in a role more oriented to systemic and public concerns. To the extent that corporate governance reform is driven by concern for integrity in capital markets and financial reporting and for assuring compliance with the law, further evolution in how directors’ roles are defined may well follow. Additionally, directors’ functions may be defined in more specific and exacting terms in connection with executive compensation decisions. In both contexts, specific organizational structures and practices are significant components of how directors may discharge their duties.

1. Legal compliance — Recent events illustrate increased willingness on the part of

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42To be sure, some commentators believe that reform has already gone too far. See Editorial, CEO Justice..., WALL ST. J., Mar. 16, 2005, at A24 (arguing that conviction of former CEO of WorldCom calls into question need for regulatory burdens imposed by SOX; “[n]ow that the man at the center of the biggest accounting fraud in U.S. history will pay for his own crimes, it is only fair that the rest of American business shouldn’t have to.”).
boards to end the tenure of a CEO who is implicated in legal, regulatory, or ethical difficulties.43 Fear that the taint of scandal will reach the company itself appears to have strengthened the capacity of boards to take prompt and preclusive action.

Separately, SOX section 307 required rulemaking by the SEC to establish minimum standards for lawyers appearing before the SEC when a lawyer has evidence of a material violation of securities law or breach of fiduciary duty by a company or any agent of the company.44 The rule adopted by the SEC requires reporting such evidence up-the-ladder within the corporation to its chief legal officer or to both the chief legal officer and the chief executive officer.45 The chief legal officer has the responsibility to make inquiry into the evidence; alternatively, the chief legal officer may refer a report of the evidence to a qualified legal compliance committee (a “QLCC”) previously established by the company.46 If the company has established a QLCC, a lawyer who becomes aware of evidence of a material violation may report the evidence to it, in lieu of reporting to the chief legal officer. If the lawyer reports evidence of a material violation to the chief legal officer, the reporting lawyer has a duty to assess the appropriateness of the response received and, if no such response is received within a reasonable time, to report the evidence to the company’s audit committee, to another board committee composed solely of independent directors, or to the entire board.47 However, if the lawyer instead

43See Barrioneuvo, supra note 14.
45See 17 C.F.R. §205.3(b)(1).
46Id. § 205.3(b)(2).
47Id. § 205.3(b)(3).
reports the evidence to a QLCC, the lawyer has discharged the lawyer’s responsibility and has no further responsibility to assess the QLCC’s response.48

QLCCs occupy a position somewhat similar to audit committees.49 Like an audit committee, a QLCC is an internal organ of corporate governance with an important linkage function to external authority, in this case the SEC. Under the SEC’s rule, a QLCC must have the authority and responsibility to inform the chief legal officer and CEO of any report of evidence of a material violation, determine whether and how to investigate, recommend that the company implement an appropriate response at the conclusion of its investigation, and, if the company fails to implement an appropriate response, to notify the SEC.50 Unsurprisingly, the SEC’s rule also imposes independence requirements for QLCC membership. A QLCC must include at least one member of the company’s audit committee, plus two or more directors who are not directly or indirectly employed by the company.51

2. Compensation Decisions and Compensation Committees — Corporate governance reforms also focus on the structure and functioning of boards’ compensation committees. For example, the NYSE’s 2003 governance rules require that a listed company have a compensation committee composed solely of independent directors.52 The committee must have a written

48 Id. § 205.3(c).

49 For further development of this analogy and a pessimistic assessment of the likelihood that QLCCs will succeed as a mechanism for reducing misconduct, see Jill E. Fisch & Caroline M. Gentile, The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors, 53 Duke L. J. 517 (2003).

50 Id. § 205.2(k).

51 Id. § 205.2(k)(1).

52 NYSE CORPORATE GOVERNANCE RULES, supra note 29, Rule 5(a).
charter addressing its purpose and responsibility, which must include direct responsibility to
“review and approve corporate goals and objectives relative to CEO compensation, evaluate the
CEO’s compensation in light of those goals and objectives, and, either as a committee or
together with the other independent directors (as directed by the board), determine and approve
the CEO’s compensation level based on this evaluation....”53 If the committee is assisted by a
compensation consultant – distinct from the company’s human resources department – the
committee’s charter must give it sole authority to retain and terminate the consultant, including
sole authority over fees and other terms.54 Reposing direct authority for a consultant’s
engagement in the compensation committee may serve to counter a history of CEO involvement
in the process through which the company’s human resources department selected consultants.55

Compensation committee processes may evolve to resemble more closely some of the
hallmarks of audit committees. One likely focal point for such evolution is the committee’s
relationship with compensation consultants it engages, stimulated by concern that the consultant
be (and appear to be) free of allegiances to the company’s senior management.56 Should a
compensation committee be hesitant about engaging a consultant with prior ties to the company
and its CEO, for example, a consultant previously retained by the company’s management? And

53 Id., Rule 5(b)(i)(A).
54 Id., Commentary to Rule 5.
55 See BEBCHUK & FRIED, supra note 2, at 38.
56 Another possible direction for evolution is for compensation committees to retain
special counsel from outside the company to draft and negotiate provisions in executive
employment agreements. that of the CEO. Although the company’s internal general counsel
might do such work, a shift to external special counsel may be warranted by the hierarchical
relationship between an internal general counsel and the CEO.
should the committee be hesitant to engage a consultant from a firm that does substantial other work for the company?\textsuperscript{57} Of course, a compensation committee’s function is not identical to that of an audit committee, just as a compensation consultant’s role, advising its clients, does not mirror an auditor’s role. Nonetheless, to the extent a compensation committee wishes to rely on the advice it receives from its compensation committee, its ability to do so will be enhanced by the consultant’s independence from management.

IV. LOYALTY AMPLIFIED

\textit{A. \textit{Heightened Expectations of Affirmative Engagement}}

Sustained reform in corporate governance requires more than compliance with formal processes and definitions of independence. However, the cumulative impact of compliance with formal requirements, occurring as it does within the complex of factors that shape directors’ conduct, may undergird directors’ ability to act effectively on matters not explicitly addressed in the formal requirements themselves. Mandated discussion by boards of whether individual directors satisfy definitions of independence, albeit awkward at times, focuses collegial attention on the traits that underlie a capacity for independent action. Additionally, the cumulative impact of formal requirements specifying directors’ responsibilities underscores the gravity of the service they have undertaken to perform.

Consider in this light how statutory and regulatory developments serve to highlight for

\textsuperscript{57}Put differently, if the bulk of the firm’s income from a client comes from actuarial and other services it provides to the client’s human resources division, its ability to provide independent advice concerning the CEO’s compensation may be called into question, just as one might reasonably question the ability of a firm to provide credible service as an auditor when most of its income stems from audit services. As is well known, SOX prohibits an auditor’s provision of specified non-audit services to its public company audit clients. SOX § 201, 15 U.S.C. § 78j-1(g).
directors the salience of self-dealing transactions. SOX section 406 mandated rulemaking by the SEC to require that a company disclose in its annual report of whether it has adopted a code of ethics for its senior financial officers. The same section also mandated rulemaking requiring “immediate disclosure” by a company of “any change in or waiver of” its code of ethics for senior financial officers. Likewise, the NYSE required adoption and disclosure of a “code of business conduct and ethics for directors, officers and employees,” and prompt disclosure of waivers of the policy for directors or executive officers. The NYSE requires that the policy both prohibit conflicts of interest and provide means through which potential conflicts may be communicated to the company. Finally, SOX section 402 prohibits personal loans via “the extension of credit” by a company to its directors and executive officers, except for certain consumer and other loans made by a company in the ordinary course of its business on terms no more favorable than those available to the general public. All reinforce the underlying point that directors may reasonably be expected to be careful and on occasion skeptical about transactions in which fellow directors or members of senior management deal with the corporation as adverse parties in transactions.

58 Item 406, SEC Regulation S-K.
59 Form 8-K, Item 5.05.
60 NYSE CORPORATE GOVERNANCE RULES, supra note 29, Rule 10.
61 Id.
62 15 U.S.C. § 78m(k). The counterpart in the U.K. is Companies Act 1985, § 330, which categorically prohibits loans by a company to its directors and persons connected to them.
63 Skepticism about related party transactions may be warranted more generally. A recent study finds a negative relationship between industry-adjusted returns and the number and value of related party transactions with non-executive directors, as well as the number and value of

Moreover, adverse market reactions to disclosure of related party transactions may indicate that the transaction is viewed as a marker of deeper and yet-unidentified problems within a company, as opposed to an adverse reaction confined to the reported transaction itself. See David Yermack, Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns (unpublished manuscript, available at http://www.stern.nyu.fin/pdfs/seminars/041f-yermack.pdf) Professor Yermack’s study of market responses to personal use by CEOs of company aircraft shows that stock prices fall by an abnormal 2% around the time of the disclosure, a much larger fall than that implied by the direct cost of the aircraft use itself. “One might conjecture that CEOs who consume excessive perks may be less likely to work hard, less protective of the company’s assets, or more likely to tolerate bloated or inefficient cost structures. High corporate perks might also occur due to weak corporate governance.” Id. at 2.

64 NYSE CORPORATE GOVERNANCE RULES, supra note 29, Rule 3.

65 Id., Commentary. If one director is chosen to preside, the company’s proxy statement must disclose that director’s name. Alternatively, if the decision is to rotate the presiding position, the proxy statement must disclose how a presiding director will be chosen for each session.
on a particular matter or the willingness to do so. In particular, these cases illustrate both the
inhibitions to which directors may be or appear to be subject as a consequence of ties to persons
interested in a decision to be made by the directors, as well as judicial capacity to explore these
questions in a nuanced fashion. Separately, the cases also illustrate a range of situations in
which, for whatever reason, formally disinterested directors may not have acted without
appropriate fidelity to the best interests of the corporation.

1. Directors Enmeshed in Social Institutions — Consider first the possibility that a
director may be enmeshed in ties with persons who have a direct interest in a decision to be
made by the director, ties that may elude more objectively-articulated criteria for assessing a
director’s disinterest. The presence of such ties should come as no surprise, given the fact that
many people who are suitable for service as non-executive directors are likely to be people with
manifold ties to others.66 As one court stated the point: “corporate directors are generally the sort
of people deeply enmeshed in social institutions...[which] have norms, expectations that
explicitly and implicitly, influence and channel the behavior of those who participate in their
operation.”67 Nor is there good reason to suppose that better service as a director will come from
a person who proceeds through life in isolation of the diverse range of institutions – educational,
political, cultural, religious – through which social life proceeds and allegiances are formed.
Nonetheless, it is wise to acknowledge that a director’s participation in social networks can reach
such a degree of intensity that the director’s ability to act independently regarding a person with

66 For the same point in connection with lawyers’ conflicts of interest, see SUSAN P.

67 In re Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003).
whom the director is interconnected can reasonably be open to doubt.

These points are developed most elaborately by the Delaware Court of Chancery in 2003 in *In re Oracle Corp. Derivative Litigation*. In *Oracle Corp.*, the question was whether two non-executive members of the company’s board were sufficiently independent to serve as a special litigation committee to assess the merits of a derivative suit brought by shareholders against the company’s chairman and its other directors. The suit alleged that the chairman and the other directors sold Oracle’s shares illegally when they possessed material non-public information showing that the company would not meet a quarterly earnings forecast. Under Delaware law, a special litigation committee, comprised of disinterested directors, may evaluate the merits of a derivative suit when a majority of the corporation’s directors are named as defendants in the suit.68 However, it is necessary that the directors who are members of a special litigation committee be independent, which has been interpreted to require a determination whether there is any “substantial reason” that the director is “incapable of making a decision with only the best interests of the corporation in mind.”69

In *Oracle Corp.*, the court held that substantial reason existed to conclude that members of Oracle’s special litigation committee lacked the capacity – or at least the evident capacity – to act with the requisite degree of impartiality in assessing the merits of the derivative suit against their fellow directors. The two directors who comprised the litigation committee were appointed to the board following the trading challenged in the suit, and both were senior (and tenured)

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68 See Deborah A. Demott, Shareholder Derivative Actions § 5.16 (2004).

members of the Stanford University faculty, all facts that one would think would help establish their capacity for impartial judgment. However, various defendants in the derivative suit also had extensive ties to Stanford. For example, one director-defendant was another Stanford professor who taught one of the special committee members during his PhD program. Another director-defendant was a Stanford alumnus who had given millions of dollars to the university in recent years, including hundreds of thousands of dollars to the school of one of the committee members and to a research institute with which one of the committee members was affiliated. Oracle’s chairman was, as it happens, during the same time publicly considering whether to make very large contributions to Stanford.\footnote{As the court notes, during the same time Stanford denied admission to a child of Oracle’s chairman. Although the committee argued that this fact evidenced its independence, the court treated it as having equivocal significance because the admissions denial might “as likely manifest itself in a desire on the part of the Stanford community never to offend [Oracle’s chairman] again, lest he permanently write off Stanford as a possible object of his charitable aims–as the sort of thing that acts not as one, but as two strikes, leading the batter to choke up on the bat so as to be even more careful not to miss the next pitch.” \textit{Id.} at 946.}

In short, the directors who comprised the litigation committee were, like the director-defendants, members of a relatively small and closely-knit community in which a determination that a colleague should be exposed to the ravages of shareholder litigation was likely to trigger more than an isolated instance of social awkwardness.

Unsurprisingly, not all social ties among directors create a comparable degree of skepticism about a director’s capacity for independent judgment. In \textit{Beam v. Stewart}, another
recent case assessing directors’ independence in the context of derivative litigation, the Delaware Supreme Court examined social ties between the homemaking doyenne, Martha Stewart, and members of the board of her company, Martha Stewart Living Omnimedia, Inc. (“MSO”). The plaintiff alleged that Stewart and MSO’s directors “moved in the same social circles, attended the same weddings, developed business relationships before joining the [MSO] board, and described each other as ‘friends’ ....” Even coupled with the fact that Stewart held 94 percent voting power in MSO, that she and her company’s non-executive directors occupied the same social circles did not, in the court’s assessment, rebut the presumptive independence of MSO’s non-executive directors to assess claims against Stewart. Given the gravity of the claims against Stewart – later convicted of lying to federal agents in connection with statements she made about her trading of shares in another company – the court recognized that MSO’s directors would jeopardize their own reputations were they to fail to act independently in assessing the shareholders’ claims against Stewart. In the court’s view, what’s determinative is whether the facts alleged by the plaintiff support the inference that a director “would be more willing to risk his or her reputation than risk the relationship with the interested director.”

845 A.2d 1040 (Del. 2004).

Id. at 1051.

Id. at 1052. Beam distinguishes Oracle Corp. on the basis that the Stanford ties were “factually distinct” from the social relationships involved in Beam, id. at 1054. Moreover, the contexts in which the courts assessed the directors’ independence in the two cases are distinct. In Beam, the issue was whether the court should permit the derivative suit to proceed notwithstanding the plaintiff’s failure to make a demand on the corporation’s directors that they pursue the claim against Stewart. Delaware excuses a plaintiff’s failure to make such a demand prior to filing a derivative suit only when the complaint alleges facts that raise a reasonable doubt that it would be futile to make a demand on the board. Demand futility means either that a majority of the directors are not disinterested regarding the claims in the suit or that the directors’ underlying decision would not be protected by the business judgment rule. In contrast,
2. Toward an Active Conception of Loyalty — Several recent cases recognize that directors who satisfy formal criteria of disinterested independence may also manifest a troubling degree of uninterest in the company and its fortunes. To be sure, some degree of uninterest is defensible and, indeed, desirable lest directors be overwhelmed by relative minutiae. The interesting question is whether – or under what circumstances – a court should characterize disinterested directors’ uninvolved or underinvolved in the conduct of corporate affairs as a breach of duty. Overall, a number of recent cases articulate expectations for a director’s loyalty to the corporation that extend beyond financial disinterest in decisions made by the director to a more affirmative standard of fidelity that, under some circumstances, requires that a director take action and subjects the director to individual liability to the corporation when the director fails to do so. These cases complement the sharpening of expectations of directors’ conduct through increased specification of their duties and the processes through which duties should be discharged.

Recent cases delineate distinctions between a justifiable decision by directors to delegate a matter to others deeper within the corporation and a culpable failure by directors to act to advance the corporation’s interests. Cases finding a basis for a claim fall into two categories: (1) directors’ failure to act notwithstanding notice that the corporation is beset by legal or regulatory difficulties; and (2) directors’ failure to act notwithstanding notice that the corporation’s interests are subject to some other substantial risk. In the first category, consider the facts alleged in In re ___

in the context of a determination made by a special litigation committee, the committee “has the burden of establishing its own independence by a yardstick that must be ‘like Caesar’s wife’ – above reproach.” Id. Beam recognizes but takes no position on the question of whether the substantive standard applicable to assessing directors’ independence differs in the two contexts.
Abbott Laboratories Derivative Shareholders Litigation.\textsuperscript{74} The plaintiff alleged that the corporation’s 13 directors, 11 of whom were non-executive directors, had notice that the corporation had had non-compliance problems with the federal Food and Drug Administration, problems that led eventually to payment of a civil fine of $100 million, the mandated destruction of inventory, and withdrawal from the market of 125 types of medical diagnostic tests. As alleged in the complaint, the directors ignored the non-compliance problems despite awareness that continued failure to comply with the FDA’s regulations would result, as it did, in substantial penalties.\textsuperscript{75} Nor, the complaint alleged, did the directors reprimand corporate personnel involved in violating FDA regulations. The court held that the complaint’s allegations sufficiently pleaded conduct by Abbott’s directors that would fall outside the protection of the business judgment rule. Abbott’s directors engaged in “conscious inaction” in the fact of notice of substantial risks to the corporation, conduct that would breach the duty of good faith that directors owe the corporation.\textsuperscript{76} Such “conscious inaction” is not, in the court’s analysis, a mundane violation of directors’ duty of care or a well-intended exercise of business judgment gone awry. Instead, it is consistent with an inference that the directors made a conscious decision not to do their job.\textsuperscript{77}

\textsuperscript{74}325 F.3d 795 (7th Cir. 2003). Although the corporation was incorporated in Illinois, the court draws heavily on Delaware law. \textit{Id.} at 802.

\textsuperscript{75}The $100 million fine was the largest assessed to date by the FDA. \textit{Id.} at 800.

\textsuperscript{76}\textit{Id.} at 809. \textit{See also} McCall v. Scott, 239 F.3d 808 (6th Cir. 2001)(applying Delaware law; directors’ reckless conduct encompassing conscious disregard of known risk constitutes breach of duty of good faith).

\textsuperscript{77}An influential Delaware case established that a director’s sustained indifference to legal compliance by others within a corporation might subject the director to liability. \textit{See In re Caremark Int’l Inc. Derivative Litig.}, 698 A.2d 959, 971 (Del. Ch. 1996)(directors’ failure in a sustained or systematic manner to exercise oversight and monitoring functions, such as by an “utter failure to assure that a reasonable information and reporting system exists,” would subject
The practical consequence of this distinction is that, under Delaware law, a corporation’s charter may contain a provision exculpated directors from liability to shareholders for money damages stemming from breaches of the directors’ duty of “care” but not from breaches of duties of “loyalty” or “good faith.”78 Moreover, Delaware empowers a corporation to indemnify a director only if the director acted “in good faith.”79 The precise meaning of “good faith” in this context is open to dispute, as is whether a director’s duty to act in good faith should be understood to furnish a distinct basis for liability or furnish a basis on which a court should determine whether a director complied with the director’s other duties.80 My own reading of recent cases in which the prospect of liability turns on a breach of the duty of good faith is that liability requires more than negligent conduct. Instead, a viable claim for breach of a director’s duty of good faith requires facts from which it can be inferred that the director consciously disregarded the director’s duties, in particular duties to monitor conduct of others within the directors to liability for loss to corporation caused by subordinates’ violations of law).

78Del. Code Ann., tit. 8, § 102(b)(7). Under Delaware law, an exculpatory provision may not eliminate or limit a director’s liability for any breach of the duty of loyalty, illegal payments of dividends and other distributions, any transaction from which the director derived an improper personal benefit, liability involv[ing] intentional misconduct or a knowing violation of law,” or “acts or omissions not in good faith.” State corporation statutes are not identical on this point. Some allow exculpatory provisions that reach more broadly than provisions governed by Delaware law. For example, under the Nevada statute, an exculpatory provision may exclude all liability save that stemming from illegal payments of dividends or “acts or omissions which involve intentional misconduct, fraud, or a knowing violation of law.” Nev. Rev. Stat. § 87.037(1).

79Id. § 145(a).

corporation by maintaining awareness, making inquiry, and intervening when warranted in light of the risk to the corporation. One might readily encompass these circumstances within the terminology of loyalty or fidelity to the interests of the corporation.

Apart from the context of legal and regulatory compliance in *Abbott Laboratories*, recent cases hold that directors may be subject to liability on the basis of conduct that manifests a conscious disregard for the directors’ responsibilities and for material risks posed to the corporation. In the best-known case, *In re the Walt Disney Co. Derivative Litigation*, the plaintiff alleged that the company’s directors permitted its CEO and Chairman unilateral freedom in setting the terms under which the company would employ a close friend of his as the president, and then similarly permitted the CEO and Chairman to determine how to characterize the circumstances of the President’s departure fifteen months later when the employment relationship soured.\(^{81}\) By characterizing the President’s departure as a termination of employment without fault, Disney’s CEO/Chairman triggered an entitlement to a large payout of cash and stock options under the terms of the President’s employment contract. As the court analyzed the allegations in the plaintiffs’ amended complaint, Disney’s directors knew that they were making decisions – decisions to acquiesce in the CEO/Chairman’s actions and determinations – without either adequate information or adequate deliberation and “that they simply did not care if the decisions caused the corporation to suffer injury or loss.”\(^{82}\)

The duty of fidelity demarcated in these cases distinguishes among the capacities of

\(^{81}\)825 A.2d 275 (Del. Ch. 2003). I testified at trial in this case on behalf of the shareholders as an expert witness concerning practices of corporate governance.

\(^{82}\)Id. at 289.
individual directors. Thus, an individual director who is especially knowledgeable or skilled who acquiesces in a transaction breaches the director’s duty to the corporation when the director knows that the transaction is unfair to the corporation or its shareholders. The duty also survives the corporation’s insolvency, with the consequence that breaches of the duty may be asserted by creditors of a corporation that has become insolvent.

V. CONCLUSION

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83See In re Emerging Communications, Inc. Shareholders Litig., 2004 WL 1305745, at **39-40 (Del. Ch., June 4, 2004)(director with specialized financial expertise and knowledge knew that controlling shareholder’s price in going-private transaction was unfair, making it “incumbent on [director], as a fiduciary, to advocate that the board reject the...price” proposed by a special committee and go “on record as voting against the proposed transaction” at the proposed price). The court focus on inferences about the director’s “mindset” that might be drawn: although financially disinterested in the transaction itself, the director either “made a deliberate judgment that to further his personal business interests, it was of paramount importance for him to exhibit his primary loyalty” to the controlling shareholder; or “for whatever reason,” the director “‘consciously and intentionally disregarded’ his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair,” quoting In re Walt Disney Co., 825 A.2d at 289.

For another illustration of unusually “inert” behavior by directors in connection with transactions with a controlling shareholder, see Report of Investigation by the Special Committee of the Board of Directors of Hollinger International, Inc, Aug. 30, 2004, available at http://www.sec.gov.Archives/edgar/data/868512/0000950123040104. Hollinger’s CEO extracted 95.2% of the company’s adjusted net income between 1997 and 2003 to himself personally, his corporate affiliates, and his allies in senior management. One mechanism was “management fees” paid to the CEO’s private corporate affiliate, in an amount approved annually by Hollinger’s audit committee. The committee approved the fees without knowing what level of compensation they would generate for the CEO and the COO and how those levels compared with compensation at other companies in Hollinger’s business. Nor did the committee know how the management fees might compare with the cost of directly employing its senior management.

84See Production Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 799-800 (Del. Ch. 2004)(allegations made by arms-length creditor state claim that “putatively” independent members of board breached duty through, inter alia, transactions with creditor affiliated with former director that placed liens on corporation’s assets and payment of substantial salaries while plaintiff’s debt went unpaid).
This paper is a study of interrelationships among legal and nonlegal institutions and mechanisms that shape expectations for directors’ conduct. Although distinct, none operates in a vacuum. Formal structures, definitions, and requirements may shape how directors discharge their responsibilities by focusing directors’ attention on their gravity and, by enabling directors to function more collegially, facilitating the development of institutions of corporate governance that function independently of senior management. Moreover, articulating the content of directors’ responsibilities with greater specificity heightens expectations that they will be fulfilled. In turn, higher expectations for directors’ conduct may serve to legitimate directors’ capacity, once elected, to exercise discretion independent of intervention from shareholders.

This larger context should matter when courts determine whether a director’s performance breaches the director’s fiduciary duties and warrants the imposition of monetary liability on the director. Structural reforms in board composition and processes, along with greater specificity in the content of the functions assigned to directors, increase the likelihood that a director will contravene reasonable expectations for engagement by directors through either unreflective acquiescence in senior management’s wishes or a sustained failure to be attentive.