The Principal Fiduciary Duties of Boards of Directors

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Introduction

I want to offer an overview of the principal fiduciary duties of boards of directors. I will speak mostly from a common law perspective. Fiduciary duties of directors were first elaborated by common law judges, operating without any guidance from the formal written law. Indeed, the company laws of the United States, and many other common law jurisdictions, contain no statement at all of the core fiduciary duties of care and loyalty. The fiduciary duties of directors are continuing to evolve, again without formal written law.

The classic statement, still found in many American law school textbooks, is that directors owe to shareholders, or perhaps to the corporation, two basic fiduciary duties: the duty of loyalty and the duty of care. I believe that this is too simple a picture. There are at least two additional core duties that directors have today: a duty of disclosure, and a duty that has no precise name, that I will call the duty of extra care when your company is a takeover target.

I want to offer, for each of these duties, a brief statement of the duty, why it exists; and how the duty is enforced or, sometimes, not enforced. I will speak about duties of directors, but these duties apply to officers also.

Duty	**Test for Whether Duty is Met**	**Remedy**
loyalty	fair process (approval by noninterested directors) or else burden on directors to show entire fairness	injunction or damages
care	business judgment rule	none, except in very extreme cases. In U.S., charter can eliminate liability outside directors for breach
disclosure	disclose all material information when seeking shareholder approval, or when a conflict of interest exists	corrective disclosure or damages
extra care when selling company	no clear test; careful scrutiny of decision process	injunction or damages

Duty of Loyalty

The most important fiduciary duty is the duty of loyalty. The concept is simple: the decision makers within the company should act in the interests of the company, and not in their own interests. The easiest way to comply with this duty is not to engage in transactions that involve a conflict of interest. We often call these "self-dealing" transactions. The concept is that the directors are dealing with themselves, and may not reach an agreement that is fair to the company. An alternative, that is accepted in most countries because a flat ban on self-dealing transactions can be impractical, especially for smaller firms, is to have

self-dealing transactions approved by a noninterested decision maker. That decision maker can be noninterested directors, noninterested shareholders, or sometimes both.

In the United States, *if* a conflict-of-interest transaction is negotiated and approved by the noninterested directors, in a manner that approximates arms-length negotiations, including the right of the noninterested directors to reject the transaction altogether, the transaction is accepted unless a shareholder proves in court that the transaction is *not* entirely fair to the company. The burden is on the shareholder to show lack of entire fairness. Otherwise, the transaction is considered invalid if challenged, *unless* the directors prove in court that the transaction *is* entirely fair to the company. The burden is on the directors to show entire fairness.

In the usual case where a range of prices can be considered fair, this shift in the burden of proof has large consequences in practice. Most public companies prefer to obtain approval by noninterested directors, rather than face the challenge of proving entire fairness in court. The most common remedy is damages. The courts are very cautious about unwinding a long-completed transaction, and will almost never do so if there is a risk of harm to a third party who has acted in good faith.

Public companies, in the common case where the company has a majority of independent directors, almost always rely on noninterested directors to negotiate and approve a conflict-of-interest transaction. Partly this is because of the legal consequences I have

described. Also, if the independent directors allow interested directors to vote to approve a self-dealing transaction, this is likely to lead to public criticism of the independent directors, as well as a lawsuit that they are likely to lose, where the principal question is the amount of damages. Even if the damages will be paid by the company rather than by the directors, few directors want to accept this sort of public embarrassment.

In my opinion, the principal value of independent directors lies in more careful review of conflict-of-interest transactions. The independent directors will not often help the company to make better business decisions. One can debate how many independent directors is enough. Indeed, in a paper written with Sanjai Bhagat, titled *Board Independence and Long-Term Firm Performance*,[1] which can be downloaded from the Social Science Research Network internet site at www.ssrn.com, we find no evidence in the United States that companies with a higher proportion of independent directors perform better than companies with a lower proportion of independent directors. But no one doubts that having some independent directors is important, and that a core task for the independent directors is to review proposed self-dealing transactions. These directors, especially if they are supported by strong accounting disclosure rules, by a strong financial press that can report misdeeds and embarrass directors into behaving well, and by liability rules that expose directors to

[1] Sanjai Bhagat & Bernard Black, *Board Independence and Long-Term Performance* (working paper 2000), available at http://papers.ssrn.com/paper.taf?abstract_id=133808.

personal liability if can approve transactions that are grossly unfair to minority shareholders, can help to ensure that the company's profits are shared more equally by inside and outside shareholders.

I want to stress that the rules that work reasonably well in the United States may not work as well in other countries. Many countries have a weaker tradition of independent directors, greater cultural tolerance for conflict-of-interest transactions, and judges who are less willing to review transactions to determine whether they are in fact fair to minority shareholders. In these countries, review by independent directors, and the possibility of later review by a judge, may provide too little protection to minority shareholders. It may be important to also require approval by noninterested shareholders, or other procedures designed to limit the extent of self-dealing.

More broadly, effective protection against self-dealing requires a complex network of institutions, of which review by independent directors is only one element. There is a real danger, in a conference like this, that we will pay too much attention to the role of the board of directors in reviewing self-dealing transactions, and too little attention to other important institutions. I review these other institutions in a recent article on *The Legal and Institutional Preconditions for Strong Securities Markets*, that is also available through the internet at www.ssrn.com[2]

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[2] Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 **UCLA Law Review** 781-858 (2001), available at http://papers.ssrn.com/paper.taf?abstract_id=182169.

Duty of Care

The second core duty of directors, in situations where they do not have a conflict of interest, is the duty of care -- the duty to pay attention and to try to make good decisions. I often encounter surprise about how little the duty of care requires the directors to do. They do not have to make sensible decisions. They only have to show up, pay attention, and make a decision that is not completely irrational.

American courts simply do not hold directors liable for business decisions, made without a conflict of interest, unless those decisions are completely irrational. The doctrine of noninterference is known as the business judgment rule. It has several justifications. First, courts are bad at second-guessing in hindsight decisions that turned out poorly. Second, an investment in a business can turn out badly, for a whole host of reasons. Bad management decisions are only one of these reasons. They are a risk that shareholders knowingly assume. Third, some risky decisions will work out wonderfully, while others will work out terribly. If the directors risk being found personally liable for bad outcomes, they will be reluctant to take risks, and we will get fewer really good decisions also. We may not get better decisions on average, just more cautious decisions.

The business judgment rule can be understood more easily if we look at the multiple constraints that lead most company managers, most of the time, to work hard at their jobs.

If constraints like product market competition, and the market for corporate control, and the managerial labor market, and incentive compensation, and managerial culture, and the statement in the company law that directors are supposed to try hard, directed at responsible adults who try to do their jobs, taken together, do a pretty good job of motivating directors to try reasonably hard, *and* second-guessing can chill risk-taking, then it can make sense to instruct judges not to second-guess even decisions that they think are truly terrible.

My favorite story, when I explain the business judgment rule in transition countries, where lawyers often believe that directors should be liable for bad decisions, goes like this. Imagine a company whose business strategy consists of, this year, spending $10 billion to build several new factories, to sell products they haven't yet developed, to customers they don't yet have. The strategy will succeed only if the market grows by at least 30% this year, and if their engineers can turn plans for new products into real products on time. If they succeed, they will do the same thing next year, only on a larger scale. If they fail, the factories will sit idle, and the equipment in them will be obsolete within five years. The chief executive officer of the company has been quoted in the business press, where he describes this strategy as being like driving a car at 150 kilometers per hour, along a winding mountain road, in the dark, with the lights out, trying not to crash.

This strategy is guaranteed to crash, sooner or later. The company's managers just don't know when. When the crash comes, do we want a judge to look at this strategy, and

the CEO's explanation, and hold the directors personally liable for the damage? If we are ever going to hold directors liable for negligence, this is a pretty good case for doing so. Or do we want to allow directors to take wild risks, in the hope of achieving wild success? The business judgment rule lets directors take risks, even wild risks.

There is a twist to this story. The company is Intel, which is one of the world's most successful companies. The CEO who described his business strategy as like driving at high speed down a mountain road in the dark is Andy Grove. Intel in fact crashed last year. It was, after all, only a question of when they would crash, not if. But Intel is still a big, successful company, and long-term investors are very happy with their investment.

I strongly believe that judges shouldn't penalize directors who make honest mistakes. The gains from second-guessing are too small, and the costs in chilling risk-taking are too great. So I am a strong supporter of a strong form of the business judgment rule, but coupled with strong enforcement in the very different situation where managers face a conflict of interest.

The Duty of Disclosure

The third core fiduciary duty of directors, which has emerged in American company law over about the last 15 years, and has been required for public companies for a long time in our securities law, is to provide reasonably complete disclosure to shareholders in two cases: when shareholders are asked to vote, and when the company completes a conflict-of-interest transaction. The justification for full disclosure before a shareholder vote is obvious: Without good disclosure, the shareholders may not know how to vote. The justification for full disclosure of conflict-of-interest transactions is two-fold. First, the disclosure allows shareholders to sue, claiming a violation of the duty of loyalty. Second, disclosure, without more, will deter some conflict-of-interest transactions from being completed.

The question of what remedy to impose for a violation of the duty of disclosure is difficult. If the lack of disclosure is discovered soon enough, corrective disclosure is possible. But suppose the weak disclosure is discovered long after a shareholder vote has been taken and the transaction has been completed. What remedy then? There are several problems with designing a sensible remedy. First, we usually can't know whether better disclosure would have changed the outcome of the vote. Second, it seems harsh to hold the directors liable, in the common case where weak disclosure was not the result of intentional concealment, but instead the result of a judgment call about how much to say. Especially since often, these judgment calls are made not by the directors but by the lawyers who write the information statements that the company sends to shareholders as part of a shareholder vote.

In the United States, these problems are still largely unresolved. An approach that makes sense to me is to require the plaintiff, when making a claim of bad disclosure involving a shareholder vote, to provide some evidence that better disclosure could plausibly have changed the outcome of a shareholder vote. But if the plaintiff satisfies this threshold test, I still don't know what a good measure of damages would be.

When the disclosure involves a conflict-of-interest transaction, without a shareholder vote, there is no obvious remedy. Once a shareholder learns the true facts, he can bring a duty of loyalty lawsuit directly, and recover damages or not. The violation of the duty of disclosure, although it made it harder for shareholders to uncover the true facts and bring the duty of loyalty claim, is not directly relevant once the claim is brought. Perhaps one could hold the directors liable if there was a gross failure to put into place procedures intended to ensure good disclosure. Or perhaps, if there is not proper disclousre, the directors should retain the burden of showing that the transaction was entirely fair.

There must be some remedy, to ensure reasonable compliance. But I do not yet have a strong personal view on what the remedy should be in different situations.

The Duty of Extra Care When Your Company is Being Acquired

The final duty I will discuss lacks a proper name. In a variety of ways, judges scrutinize decisions by the board of directors of a target company in an acquisition much more closely than other decisions not involving a conflict of interest. The courts could justify this intervention on the grounds that the target's board of directors faces a conflict of interest, involving at the least the likely loss of their positions. They have chosen instead to treat independent directors as noninterested -- to ignore this conflict. At the same, time, judges are faced with numerous cases where supposedly noninterested directors act as if they were interested. They also recognize the unique importance of the sell-the-company decision. Thus, American courts have imposed special scrutiny on the decisions that directors actually make. The only cases in recent memory where the courts have found a violation of the duty of care involve takeover decisions. Takeover defenses are permitted in the United States, but are subject to a special, intermediate level of scrutiny, somewhere between the nonreview reflected in the business judgment rule, as used in duty of care cases, and the very careful review reflected in the entire fairness test used in duty of loyalty cases.

In other countries, notably the United Kingdom, special rules limit takeover defenses. The concept is that the shareholders, not the board of directors, should decide whether an unfriendly takeover offer should succeed or fail. That concept is founded, in turn, on a degree of distrust as to how the directors will behave in this situation.

Either way, the remedy is either an injunction, before the transaction is completed, or more commonly, an action for damages after completion.

My remarks today are on the core fiduciary duties of directors, not on what good rules for takeover would be. Takeover rules are a separate and large topic. My views on that topic are contained in an article I wrote several years back with Reinier Kraakman, titled *A Self-Enforcing Model of Corporate Law*, also available from www.ssrn.com My overall judgment is that the British approach, in which shareholders decide whether a takeover should proceed, is preferable to the middle road adopted by the U.S. courts. But I will stop here, to leave time for discussion.