REFORMULATING THE STANDARD OF CARE OF COMPANY DIRECTORS

In this article the author assesses the Commonwealth and United States law as to the liability of company directors in negligence. These rather lax common law standards have frequently drawn criticism from commentators. A survey is then made of some empirical researches into the functions of modern company directors. The author concludes by developing a proposal for a reformulation of the present law to take into account the different kinds of decisions directors make, their varying professional and commercial backgrounds and contemporary business practice.

INTRODUCTION

In recent times there have been signs of an increased awareness on the part of some courts that the traditional rules of company law, developed largely towards the end of the last century, are in need of modification to meet modern business conditions. In this paper it is proposed to examine the rules of law in both the United States and England regarding the liability of company directors for negligence. This discussion will be followed by a survey of some studies which have been carried out in the United States of the role and function of the modern company director. Finally, on the basis of this empirical information, proposals for a reformulation of the present law will be put forward for consideration.

Before proceeding with each of these proposals, one matter concerning terminology should be explained. For, in the United States the special concession the law makes to business efficacy when formulating the standard of care and skill expected of company directors has been termed "the business judgement rule".[1] This phrase is not to be found in any English or Commonwealth case though the law on both sides of the Atlantic is very similar and rests on identical legal theory and policy. Nevertheless this readiness by American courts to label in this way is not without difficulties. It can lead to confusion about the different obligations company directors owe to the organisations they head. Thus in beginning this investigation of the rule its legal foundation should be made clear. In both countries courts have long separated the fiduciary responsibilities of company directors from their

[1] A phrase which is confusing in that it suggests a basis for liability. See Note, 7 St. Louis U.L.J. 151 (1962).

ordinary common law duty of care. It is the contrast between these two kinds of obligations which is the essence of the business judgment rule. Liability for breach of fiduciary duty rests on special grounds which will be discussed shortly.[2] In questions involving duty of care, the courts concede that a duty exists but will not find in favour of a breach if, in the absence of fraud or dishonesty, the matter was within what they perceive as the sphere of proper business discretion.[3]

The courts refuse to go further in such cases and examine the merits of a decision which they consider is without their competence to judge. Thus in *Smith* v. *Prattville Manufacturing Co.*[4] the Court said:

> Managers of corporation affairs . . . stipulate to the stockholders no more than good faith and reasonable diligence: where these are not wanting, mere errors of judgment on the part of such managers do not entitle a stockholder to relief in a court of chancery.

Running through many of the cases both in the United States and in England is concern that a court in undertaking a review of a previous business decision must necessarily do so with the benefit of hindsight and that this should make it very chary about finding directors wanting. Another popular line of reasoning is that if the courts were to engage in an active review of business decisions they would deter many directors from assuming office and risking legal liability for decisions gone sour.[5] Part 1 of this article will examine statements of the differing judicial views.

PART 1—The development of the standard of care and skill of Company Directors in the United States and England

In eighteenth and nineteenth century England the constitution of an unincorporated partnership often consisted of a deed of settlement which named trustees of the funds and other property of the undertaking. Management was delegated to a committee of directors but some of the trustees were often directors as well. Equity regarded a director as a trustee insofar as his dealings with the corpus of the trust were concerned. Gladstone's Joint Stock Companies Act of 1844

[2] See text accompanying n. 9, Note 7 St. Louis U.L.J. 151, 156 (1962) and *Bayer* v. *Beran,* 49 N.Y.S. 2d 2 (1944).

[3] One commentator sees the rule as having the function of a tool whereby the courts determine the extent to which they will review business judgments, citing as evidence two cases in which complaints alleging mere negligence were dismissed without a hearing on the merits; Note, 35 Geo. Walsh. L. Rev. 562, 563 (1967). In one case, *Casson* v. *Bosman,* 137 N.J. Eq. 532; 45 A.2d 807 (1946), however, the reported judgment indicates a consideration of the evidence and the other, *Raynolds* v. *Diamond Mills Paper Co.* 69 N.J. Eq. 299; 60 A. 941 (1905) is not an ordinary negligence action but a suit for unreasonably refraining from declaring a dividend. Cf. *Clayton* v. *Farish,* 191 Misc. 136, 158; 73 N.Y.S. 2d 727, 749 (1947).

[4] 29 Ala. 503, 509 (1857).

[5] See *Barnes* v. *Andrews,* 298 F. 614, 617 (1924).

made possible the registration of these deeds of settlement which were required to name at least three directors.[6] In 1856 the Joint Stock Companies Act of that year introduced the modern concept of incorporation by means of the registration of a memorandum and articles of association. The model schedule of articles (now Table A) of the Companies Act 1948 was, however, based upon the provisions typically included in the early deeds of association. Much of the confusion about whether or not directors were trustees occurred because of this deed of settlement mode of incorporation and was reinforced by the fact that the courts of equity had long had jurisdiction in partnership matters and also began to deal with actions against directors.[7] It would be inappropriate here to embark on an extended discussion about why directors are not trustees in the strict sense but several features of their position which differentiate them from ordinary trustees can be noted in passing:

(a) They do not possess title to the property of the corporation although it is in their control and to that extent they are accountable for their handling of it.

(b) Ordinary trustees must act together but directors may act individually or in small groups.

(c) The courts have never been willing to review the exercise of business discretion by directors on the merits. This is the most popular meaning of the business judgment rule in the United States.[8]

English courts have stated on numerous occasions that directors occupy a fiduciary position and must, as a consequence, exercise their powers in good faith and for the benefit of the company as a whole. In *Re Lands Allotment Co.*[9] Lindley L.J. states:

> Although directors are not properly speaking trustees, yet they have always been considered and treated as trustees of money which comes to their hands or which is actually under their control; and ever since joint stock companies were invented directors have been held liable to make good moneys which they have misapplied upon the same footing as if they were trustees . . .

After the fusion of law and equity in England the common law courts, with an appreciation of commercial reality, began to wear down the higher standards imposed by the equity courts. Directors are still strictly liable as to their handling of the company's assets, in cases of active misapplication. They are similarly accountable for secret profits

[6] 7 & 8 Vict., c. 110.

[7] See Sealy, "The Director as a Trustee" [1967] Camb. L.J. 83.

[8] For a discussion of the meaning of the business judgment rule see Dyson, "The Director's Liability for Negligence", 40 Ind.L.J. 341 (1965) and see text accompanying n.27.

[9] [1894] 1 Ch. 616, 631.

made in contracts between themselves and their company.[10] But in respect of their standard of care and relationship to individual shareholders the trust analogy is inapplicable. The managers of a business enterprise must take risks and it is expected by investors in such undertakings that they will do so. The common law recognised this in making it quite clear that it was unwilling to make directors accountable for their actions when they had acted honestly but their decision had caused loss to the company.

The leading statement of what English law sees as the standard of care owed by directors to their company is still that of Romer J. in *Re City Equitable Fire Insurance Co. Ltd.*[11]

> There are, in addition, one or two other general propositions that seem to be warranted by the reported cases: (1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so. (3) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

The first section of this enunciation of duty parallels the approach of many American courts. The second is, however, more lax than the trend of authority in that country and now in Australia.[12] In *Re Cardiff Savings Bank*[13] the Court refused to hold a director liable despite his

[10] In such cases the contracts are voidable where the director has sold his own property to his company; *Aberdeen Railway* v. *Blaikie* (1854) 1 Macq. (H.L.) 461; 2 Eq. Rep. 128; 23 L.T. (O.S.) 315. The same result obtains where the director has misused information properly the property of his company and this often leads to inequitable results; e.g. *Regal (Hastings) Ltd.* v. *Gulliver* [1967] 2 A.C. 134n. (H.L.). Compare this with the position in the United States where the general rule is that the transaction is subject to review by the courts and will be invalidated only if it is found to be unfair to the corporation; Marsh, "Are Directors Trustees?; Conflict of Interest and Corporate Morality", 22 Bus. Law 35 (1966). Usually this is achieved by placing the burden of proving that they acted in the corporation's best interests on the directors concerned; *Santarelli* v. *Katz,* 270 F.2d 762 (1959).

[11] [1925] Ch. 407, 428-429.

[12] See *Re Australasian Venezolana Pty. Ltd.* [1962] 4 F.L.R. 60 where a director was held liable in negligence for acting before he had properly acquainted himself with the affairs of the company.

[13] [1892] 2 Ch. 100.

not having attended a board meeting in 17 years![14] Despite some hopeful suggestions to the contrary the general trend is a permissive one.[15] If a director does attend meetings though, he is presumed to have known what went on at them.[16] This problem has led Professor Gower to comment,

> Here, as throughout this branch of the law, questions of causation are of paramount importance; if a director is party to a decision to take a particular course of action it may be possible to show that this led directly to loss by the company, but it will be next to impossible to show that his laziness was the cause of the damage or that the action would have been different had he attended.[17]

In the United States the formulation of the director's duty of care has taken more varied form than has been the case in England. Before exploring the differences which have emerged in the cases and in the state codes, two deviations from the adoption of a normal negligence criterion should be noted.

United States deviations from the ordinary formulation of the standard of care

First, a substantial line of cases support the proposition that directors of banks and financial corporations owe a higher standard of care and skill than do directors of ordinary business corpoations.[18] In *Atherton* v. *Anderson*[19] bank directors were held liable for failing to discover large *ultra vires* loans made by the president and for failing to prevent him from making additional such loans. The directors had discontinued an examining committee of three directors which had formerly operated as a check on the president, had appointed an auditor whose salary was fixed by the president and had not examined reports from the national bank examiners, except such extracts as the president chose to tell them about. It has been suggested that this stricter approach stems from a judicial determination to come to the rescue of

[14] See also *Re Brazilian Rubber Plantations and Estates Ltd.* [1911] 1 Ch. 425, at 437.

[15] Re *City Equitable Fire Insurance Co. Ltd.* (supra n.11) at 429. Cf. *Kavanaugh* v. *Gould,* 223 N.Y. 103; 119 N.E. 237 (1918) and *Bowerman* v. *Hamner,* 250 U.S. 504 (1919).

[16] *Ashurst* v. *Mason* (1875) L.R. 20 Eq. 225.

[17] Gower, *Principles of Modern Company Law* (1969) 3rd ed., p. 551 (footnotes omitted). It is clear that a director is not liable with his fellows if he was absent when the alleged negligent act occurred or voted against the decision on which the suit is based; *Gerdes* v. *Reynolds,* 28 N.Y.S. 2d 622, 648 (1941).

[18] *Briggs* v. *Spaulding,* 141 U.S. 132 (1891), *Greenfield Savings Bank* v. *Abercrombie,* 211 Mass. 252; 97 N.E. 897 (1912), *Bates* v. *Dreser,* 251 U.S. 524 (1920), *Prudential Trust Co.* v. *Brown,* 272 Mass. 132; 171 N.E. 42 (1930), *Litwin* v. *Allen,* 25 N.Y.S. 2d 667 (1940), *Allied Freightways* v. *Cholfin,* 325 Mass. 630; 91 N.E. 2d 765 (1950) and *Uccello* v. *Gold'n Foods Inc.* 325 Mass 319; 90 N.E. 2d 530 (1950).

[19] 99 F.2d 883 (1938).

small depositors in these institutions, but it is not readily apparent why they should deserve more protection than that afforded small shareholders. A better explanation may be that directors of banks, as a group, are more cautious animals than ordinary company directors and that therefore the courts can more easily demand higher standards of care of them. Seen in this way the bank director exception is consistent with the suggestion that the courts in director negligence suits demand a standard of care which is commensurate with the skill displayed by directors of like companies.[20]

Second, some states still insist on a showing of gross negligence before a director can be held liable for conduct that is short of wilful.[21] One of the earliest American cases to set up such a standard and also the case regarded as containing the first clear statement in that country of the business judgment rule is *Spering's Appeal*.[22] Among the states which have the gross negligence requirement are Alabama,[23] Massachusetts[24] and Colorado.[25] In the latter the Supreme Court of Colorado has posited that:

> The directors of a business corporation other than a bank are not to be held responsible for mere errors of judgment or for want of prudence short of clear and gross negligence.

The Business Judgment Rule

Two separate statements of the duty of care directors owe their corporations emerge from an examination of reported American decisions. The first merely requires the exercise by the director of the same care and prudence that men prompted by self-interest exercise in their own affairs.[27] This test is repeated in *Hanna* v. *Lyon*[28] as the degree of care that men of ordinary prudence exercise in regard to their own affairs though limited in that case to the directors of monetary corporations. A second formulation of the standard appears in codified form in Pennsylvania where directors are to

> . . . discharge the duties of their respective positions . . . with that diligence, care and skill which ordinarily prudent men

[20] See text accompanying n.33.

[21] Some early English cases appear also to adopt such a standard though it is generally unrecognized in the modern English law of torts. See *Re Liverpool Household Stores Assn. (Ltd.)* (1890) 50 L.J. Ch. 616, 618 and *Overend & Gurney Co.* v. *Gibb* (1872) L.R. 5 H.L. 480, 487 but cf. *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, 427.

[22] 71 Pa. 11 (1872). See also *Percy* v. *Millaudon* 3 La. 568 (1832).

[23] *Sellers* v. *Head,* 261 Ala. 212; 73 So. 2d 747 (1954), approving *Van Antwerp Realty Corp.* v. *Cooke,* 230 Ala. 535, 538; 162 So. 97, 99 (1935).

[24] *Allied Freightways* v. *Cholfin,* 325 Mass. 630; 91 N.E. 2d 765 (1950).

[25] *Holland* v. *American Founders Life Ins. Co. of Denver,* 151 Col. 69; 376 P.2d 162 (1962).

[26] Ibid., 75.

[27] *Hun* v. *Cary,* 82 N.Y. 65 (1880). See also *Hodges* v. *New England Screw Co.,* 1 R. I. 312 (1850) at 346.

[28] 179 N.Y. 107; 71 N.E. 778 (1904).

> would exercise under similar circumstances in their personal business affairs.[29]

This version of the self-interest standard gives Pennsylvania courts leeway to consider, to the extent they are made aware of them, the varying circumstances of a particular corporation and its directors. In so describing the courts' approach to the question of whether a director is in breach of his duty of care to his corporation the Pennsylvania law closely approximates the tests used by the English cases of *Re Brazilian Rubber Plantations and Estates Ltd.*[30] and *Overend & Gurney Co.* v. *Gibb.*[31]

Finally, some American courts have adopted what is sometimes referred to as the "reasonable director" standard of negligence liability. Section 717 of the New York Business Corporation Law provides:

> Directors and officers shall discharge the duties of their respective positions . . . with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

Once again this test lets the courts take into account such variables as the personal qualities and positions of different directors, the kind of corporation involved and the usages of business. This test was adopted by the United States Supreme Court in *Briggs* v. *Spaulding.*[32]

Many commentators on the tort liability of directors have envisaged some increase in the standards demanded by the law in view of, to use their favourite language, the increasingly professional status of directors.[33] In the United States the business judgment rule has led to greater emphasis being placed by the courts on the facts and circumstances of particular cases and therefore they would already appear to have sufficient manoeuverability to incorporate changing expectations of how company directors should act. The impression is gained from a reading of business judgment rule decisions in the United States and England that not only are differences in the conduct expected of directors apparent between the two countries but over the years the courts in both countries seem to have demanded increasingly higher standards from directors despite their continued allegiance to familiar legal formulae. This suggests that whether or not the facts and circumstances approach is expressly adopted the standards of conduct expected of directors in the business world at a particular time will be influential in determining whether or not a breach of duty of care is found.

[29] Pa. Stat. Ann. tit. 15, s. 2852-408 (overruling *Spering's Appeal (supra)* and see *Otis & Co.* v. *Pennsylvania R. Co.*, 61 F. Supp. 905 (1945) and *Selheimer* v. *Manganese Corp. of America*, 423 Pa. 563; 224 A.2d 634 (1966).

[30] [1911] 1 Ch. 425.

[31] (1872) L.R. 5 H.L. 480.

[32] 141 U.S. 132 (1891). See also Ontario Business Corporations Act 1970, 19 Eliz. II, c.25, s. 131.

[33] See Gower, *supra* n.17, p.549 and Trebilcock, "The Liability of Company Directors for Negligence", (1969) 32 Mod. L. Rev. 499, 509.

These differences in result are not easily quantifiable and it is difficult to draw comparisons between cases due to factual differences, but at least two examples of express credence being given to changing business standards can be cited. One instance has already been mentioned — that of the English and American courts approach to the problem of the director who does not attend board meetings.[34] Another striking example is the extent to which directors can discharge their responsibilities by merely appointing competent management to perform their own responsibilities and thereafter relying on such management without being required to investigate the basis for its findings and recommendations. The English cases of the turn of the century whitewash management in such instances when they were unaware of facts which might put them on inquiry.[35] In *Dovey* v. *Cory*[36] Lord Davey in the course of his speech said:

> It was the duty of the general manager and (possibly) of the chairman to go carefully through the returns from the branches, and to bring before the board any matter requiring their consideration; but the respondent was not, in my opinion, guilty of negligence in not examining them for himself, notwithstanding that they were laid on the table of the board for reference.

In the United States there has been a discernible trend towards recognition of a requirement of greater diligence on the part of directors in situations where they have actually undertaken additional responsibilities. Thus in *Barnes* v. *Andrews*[37] Justice Learned Hand said:

> It is not enough to content oneself with general answers that the business looks promising and that all seems prosperous. Andrews was bound . . . to inform himself of what was going on with some particularly, and, if he had done so, he would have learned that there were delays in getting into production which were putting the enterprise in most serious peril.

In the most recent case of *Syracuse Television, Inc.* v. *Channel 9, Syracuse, Inc.*[38] the Supreme Court of New York was more explicit about this kind of approach. In that case several of the directors had become members of an executive committee of the board. The Court upheld the standard of care as being not only what a prudent man would have done, in similar circumstances, being in possession of the knowledge and information that the directors possessed, but also the skill which he could have acquired by diligent attention to his duties:[39]

> Having injected themselves into the more detailed management of the corporation and thereby acquired additional knowledge, they are charged with that knowledge in judging their conduct.

[34] Text accompanying n.14.
[35] *Land Credit Co. of Ireland* v. *Lord Fermoy,* (1870) L.R. 5 Ch. App. 763.
[36] [1901] A.C. 477, 493.
[37] 298 F. 614, 616 (1924). See also *Briggs* v. *Spaulding,* 141 U.S. 132 (1891).
[38] 51 Misc. 2d 188, 273 N.Y.S. 2d 16 (1966).
[39] 51 Misc. 2d 188, 197, 273 N.Y.S. 2d 16, 27 (1966).

Thus courts, in the United States at least, seem to be willing to apply the traditional standards in a way which demands more of directors in situations where they have shown themselves willing to accept greater responsibilities and a larger role in the running of their corporations. One American writer recognized this trend as long ago as 1886. In his work on private corporations Morawetz said, in criticizing the gross negligence standard of *Spering's Appeal*,[40] that directors should be held to as much diligence and care as the proper performance of the duties of their office requires. What constitutes such proper performance, he thought, must take into account, *inter alia*, the usual methods of managing such corporations.[41]

PART 2—Empirical studies of the roles and functions of the modern company director

Now that the standard of care courts impose on directors has been examined, several questions can be presented. Is it appropriate to adopt a standard of care for directors comparable to that postulated for auditors and other professionals? Has the office of director changed so greatly since the earlier cases were decided that it is now possible to speak of a "professional director" and hold him to a standard of care more in keeping with his skills and responsibilities? Is it sensible to develop different standards for those directors who are also executive officers of the corporation and those who are outsiders? What of the outsider who has no business qualifications but who is a director because of his technical competence in a specific area? Before we can hope to discuss these and other questions we must first look at the actual role and qualifications of modern directors.

(i) Nature of modern company directors

Any search for empirical studies of the role of the modern American corporation director is bound to result in disappointment. Surprisingly little work has been done in the area and that which has, often has a superficial quality about it. The principal sources were two Harvard Business School studies done 25 years apart. Though both were limited in what they sought to achieve they at least provide us with some sort of understanding of the modern function of a director against which we can examine the rules of liability discussed above. Professor J. C. Baker's study emphasized the subjectivity of the director's role and found it very difficult to generalize about what directors do or should do.[42] That of Professor M. L. Mace, on the other hand, focused on the extent to which the board of directors is dependent upon management and suggests that it is management and not the board which controls the direction in which the corporation is moving.[43]

[40] 71 Pa 11 (1872).

[41] See *Morawetz on Private Corporations* (2nd ed., Boston 1886), para. 552 and *Warner* v. *Penoyer* 91 F. 587 (1898).

[42] Baker, *Directors and Their Functions* (Boston, 1945).

[43] Mace, *Directors: Myth and Reality* (Boston, 1971).

The size of the typical board of a large or medium sized widely held corporation with the directors owning common stock is about fifteen. The inside directors will typically include the chairman, the president, an executive vice-president or two, and vice-presidents and general managers. The outside directors are usually the chairmen and presidents of well-known corporations, commercial banks and insurance corporations.[44] Often among the outsiders will be a recently retired head of the corporation.[45] Of 456 manufacturing companies covered by the 1966 N.I.C.B. Report on Corporate Directors, 27 (six per cent) had a board equally composed of inside and outside directors. Only six (one per cent) had a board composed exclusively of insiders and one had only outsiders. In 63 per cent of the boards outside directors form a majority and this trend has been growing ever since these studies were begun.[46] Eight per cent of the seats on the boards were held by former employees and 55 per cent of the companies surveyed had at least one former employee on their board.

Comparable statistics for Australia and New Zealand exist as a result of a survey carried out by an Australian firm of management consultants.[47] This study was based on a survey of 350 public companies in Australia and New Zealand, over half of which were engaged in manufacturing. The study revealed an average board size of six members. Fifteen per cent of the companies surveyed had one or more directors resident overseas. Only five per cent of the companies had exclusively inside directors, seventeen per cent had boards exclusively comprised of outside directors and 78 per cent had mixed boards. In 60 per cent of the companies surveyed outsiders formed a majority. The commonest occupation of the outside director was that of accountant and many were lawyers, former executives, "professional directors" and engineers.

[44] For a discussion of the semantic difficulties inherent in the use of the terms "inside" and "outside" to describe company directors see Louden, *The Corporate Director* (American Management Association, 1966) c. 11. In the recent case of *Escott* v. *Barchris Construction Corp.* 283 F. Supp. 643 (1968) Justice McLean defined an outside director as one who was not an officer of the corporation (at p.687).

[45] See National Industrial Conference Board Report on Corporate Directors, 1966, p. 15. In a study of 436 manufacturing companies with 2859 outside directors —

420 were bankers,
342 were retired or former corporation officers,
337 were corporation presidents,
308 were lawyers,
245 were "prominent businessmen" (otherwise unclassified),
216 were corporate chairmen, vice-chairmen and committee chairmen,
193 were retired businessmen and
139 were industrialists and manufacturers.

[46] Cf. Vance, *Boards of Directors: Structure and Performance* (University of Oregon Press, 1964) who asserts the contrary on the basis of 103 corporations surveyed. Vance contends that once the structure of a particular board has been set that pattern persists in spite of its performance! His definition of an inside director, however, includes non-employee directors who have a "significant personal investment" in the corporation and retired officers.

[47] *The Board of Directors (A Survey of Structure and Practice in Australia and New Zealand)*, Beckingsale Management Services Pty. Ltd. (1969).

In an article in the Harvard Business Review, Mr S. J. Weinberg, a former outside director, examined some of the advantages of having outside directors on a board.[48] The essence of his comments was that they provided an invaluable objective force in the governance of a corporation as well as bringing a perspective and fresh point of view. He stressed that such directors should not become involved in the day to day management of their corporation but should retain an advisory role in respect of internal management. As has already been pointed out, such directors often have valuable expertise in fields relevant to the corporation's business which makes them useful in their own right. One study concludes that outside directors are a remnant of the days when financier-speculators were prominent in business development but that under modern conditions they have serious difficulties in adapting and even surviving.[49]

Weinberg is critical of majority insider content on boards but Mace sees both benefits and disadvantages in executives also being directors. On the positive side, Mace points to the value of having insiders on the board to answer specific questions regarding the company and to enable outside directors to evaluate the quality of the corporation's management at a personal level. In addition, he argues that such participation can be a good way to raise executive morale, educate executives in top management and provide an attraction to potential management recruits. He cites three possible disadvantages of insider participation. First, the anomoly of such persons having authority in one role over their performance of another. Second, the problem of embarrassment if such directors are asked to vacate their board positions while they remain as executives. In practice this problem is often avoided by instituting a system of rotating the insider representatives on the board amongst the management elite. Third, because such executives are often specialists, they will tend to undermine the emphasis on the general overview function of the board.[50] In addition it has been argued that such directors are unlikely to challenge their peers in open board meetings but more likely to reach consensus in separate closed meetings before the board meets. Mace concludes that in order to be an effective check on the performance of management the board should not contain any insiders except the chairman and the president.

(ii) Functions of a board of directors

Both Mace's and Baker's studies seemed to agree on what the functions of a board of directors should be. Five major ones emerge:

(a) *to be a source of advice and information to management,*

(b) *to be a check on management performance,*

[48] Weinberg, "A Corporation Director Looks at His Job", 27 Harv. Bus. Rev. 585 (1949).

[49] Vance, n.46.

[50] See next para. of text, item (c).

(c) *to establish long-term corporate objectives and broad policies,*

(d) *to select the president (or chairman), and*

(e) *to act in crisis situations.*

(a) In performing this function the board helps to add to the sources of information available to management. This is particularly so in the case of directors who are also directors of other corporations and those directors who have special technical or financial expertise. Where a corporation is involved to a large degree with governmental agencies it can be to its advantage to appoint directors who are former officers of those agencies.

(b) Both studies considered that this was a crucial role of the board. The knowledge on their part that they would be questioned by the directors as to their decisions meant that members of management would ensure that they were prepared to justify them. Professor Baker emphasized the role the board played in ensuring that its officers were not involved in problems of conflict of self-interest or the possibility of self-dealing. The independent position of the board means that it should feel free to ask discerning questions of management.[51]

(c) Mace contends that the basic objectives of the corporation are in fact established by management who tell the directors the way the corporation is going and justfy it. He cites as evidence for this trend the fact that very few boards appear to disagree with management's detailed and reasoned recommendations. This does not, however, eliminate the significance of the board as a group who can provide important guidance on broader questions as well as in areas in which management may have no expertise or be unwilling to act, such as the payment of dividends and labour relations. Baker mentions that directors often tried to remove themselves from all operations so that they could concentrate on the overall policies of the corporation like expansion, new products, changes in capital structures and public relations. But in larger corporations these functions are increasingly dealt with by specialised divisions within the corporation.

(d) This is a traditional role of the board and one which ensures its control over the executive. Most boards select the senior officers as well as retaining control over executive compensation, pension and retirement policies. The Beckingsale survey states that this is also a characteristic function of boards in Australia and New Zealand. It is very important that the board ensure the appointment of competent executives and the continuity of management. Mace contends that the incumbent president usually has the greatest say in who should succeed

[51] Professor Baker urges in his study that directors strictly separate their administrative responsibility for getting things done from their trusteeship responsibility. This concept parallels the strict legal separation, explained earlier of the director's duties of good faith and due care.

him but that the board formally approves the appointment of the new president.[52]

(e) Situations of crisis are very rare in most corporations. When financial and other results are so bad that some action is forced upon the board, or the president dies in office, then the board will choose a successor. In the former instance the board will become the centre of authority but it will often be difficult for it to acquire sufficient information to be willing to take such a stand. One way in which the board can ensure that it is receiving an objective view of managerial performance is to hire management consultants to assess executive competence.[53]

This discussion of the composition and functions of the board of directors has hopefully helped clarify who exactly a company director is and what kind of decisions he makes. It is only from a clear appreciation of these two central factors that workable legal rules attaching responsibility for due care can be fashioned. At this stage we can posit three types of functions typically performed by directors:

(i) independent decisions of the board to establish long term policy, select the chairman (or president) and act in crisis situations,

(ii) decisions which amount to ratification by the board of executive recommendations, and

(iii) the provision of advice to management.

PART 3—Assessment of judicial reaction to the nature of the Company Director

All the case studies which have been carried out in the United States stress the subjectivity and uniqueness of the position of an individual director. This factor alone is enough to reject the suggestion that directors are conventional professionals with skills who should be held to standards of care in terms of a professional norm much as doctors, lawyers and accountants are.[54] In England the Jenkins Com-

[52] See Monsen and Downs, "A Theory of Large Managerial Firms", 123 J. of Political Economy 221 (1965) where the authors, in examining the problem of the bureaucratic structure of large firms tending to cause management to deviate systematically from achieving ownership objectives, note the role size and subdelegation play in abstracting the desires of top level management, at pp. 227-228.

[53] This is becoming increasingly common in Australia and New Zealand as well, according to the Beckingsale survey, see n.47.

[54] See Gower, *Principles of Modern Company Law (supra, n.14)* at pp. 549-550 and Menzies (1959) 33 A.L.J. 156, cf. Trebilcock, "The Liability of Company Directors for Negligence", 32 Mod. L. Rev. 499 (1969). In Germany directors must exercise the diligence of competent and conscientious business managers; Aktiengesetz of 1965, ss. 93(1) and 116. Under such legislation the German Supreme Court has decided that a director cannot escape liability by showing that he lacked the skill and experience necessary to manage the company's business properly. In one case it held that the

mittee on company law reform has wisely rejected the codification of this kind of a duty of care. The committee noted with approval the remarks made before it by the General Council of the Bar that:

> . . . any attempt to define the duties of directors more clearly would involve the risk that, since it would be impossible to define such duties exhaustively, there would be inevitable lacunae which might well make it more difficult to determine in any particular set of circumstances what these duties were.[55]

The director is in a position where he must often come to a decision on matters in which he has varying degrees of skill and knowledge. One Australian writer, considering such factors, despairs that any fruitful reform of the liability of directors for negligence is possible as part of a general effort to improve corporate investor protection and suggests turning into the rather crowded avenue of disclosure for help.[56] It is submitted that this conclusion is unwarranted and stems from a failure to appreciate the efficacy of the present law.

The utility of the business judgment rule has been stressed by an American writer who argues that it is an attempt to harmonize law with economic forces.[57] It should be clear by now that the director of a company must and should take risks. Business is an activity whose life's blood is innovation and unorthodoxy. In his theory of the "market for corporate control" Professor Manne develops an explanation for the efficiency of management which he relates to the price of the corporation's shares on the open market. If management is inefficient, the price of the corporation's shares will fall and as it does it will become cheaper for outsiders to acquire control of the corporation as well as increase the profitability to them of doing so.[58] If this market is working reasonably efficiently then the number of inefficient managements which survive for any long periods should be small and the need for demanding higher standards of care from directors less. The market for corporate control supplies the incentive for management to promote the best interests of shareholders and at the same time it promotes the exercise of individual initiative which is so crucial for business success.[59]

removal from office of a director of a co-operative society for failure to keep proper accounts was justified despite his plea that his general education and business experience was inadequate and that he had done the best he could. Similarly directors are not exonerated from checking each others' activities because they divided the management of the company's business between them. See Pennington, *The Investor and the Law* (London, 1968) p. 484.

[55] Report of the Company Law Committee, 1962, Cmnd. 1749, para. 87.

[56] Trebilcock, n.33.

[57] See Note, 35 Geo. Wash. L. Rev. 562 (1967).

[58] Manne, "Mergers and the Market for Corporate Control," 63 J. of Political Economy 110 (1965).

[59] For a brief discussion of the social and political background of the business judgment rule in the United States see Note, 35 Geo. Wash. L. Rev. 562, at 565-566 (1967).

If the discretion of company directors is amply kept in check by unyeilding economic forces it is no argument to say that a stricter legal standard of care should be imposed to further encourage directorial efficiency without consideration of the consequences of doing so. Even if such a standard were imposed it is very doubtful that it would, by itself, play more than an insignificant role in improving the quality of directors.[60] The effectiveness of these economic forces must still be regarded with some scepticism, however, and so long as cases of misfeasance continue to arise, the necessity of a legal duty which imposes at least a minimum standard of care referrable to contemporary good practice remains to provide compensation to those who suffer from such acts or omissions. Expert evidence from other directors seems as sound a source as any for the evolution of the business judgment rule in this manner.

The business judgment rule represents an abdication by the courts of their role as arbitrators of skill and prudence in the field of the negligence liability of directors. The courts have always expressed their reluctance to judge, with the benefit of hindsight, decisions reached by businessmen in a context where calm deliberation and clear alternatives are usually absent. This reticence is justified because it is plain that our courts are very ill-equipped to second-guess business decisions. As well as lacking technical expertise, a deficiency which could presumably be overcome by instituting special corporation courts to deal with such cases, the adversary system is unsuited to making available to the judge all the relevant information involved in the conduct being complained about. Even if we had an inquisitorial body of experts it is unlikely that it would be able to satisfactorily decide questions which are often nebulous and turn on a variety of subjective factors. Courts avoid these problems in the negligence area by relying on the business judgment rule and in cases of breach of fiduciary duty by holding the contract void or voidable and placing the burden of proving fairness on the defendant.[61]

In England the legislature has recognised the problem of relying on judicially enforced standards to regulate the conduct of company directors and has acted in several ways to deal with it.

First, provisions have been enacted which seek to ensure minimum standards of directorship. Examples of these are the provisions in the Companies Act 1948 prohibiting bankrupts from acting as company directors or taking part in the management of companies[62] and prohibiting persons being appointed directors for up to five years if they have been convicted of any serious offence connected with the promotion or management of a company, unless the Court gives its permission.[63] The Companies Act 1948 also provides for the com-

[60] See H.L.A. Hart, *The Concept of Law* (Oxford, 1961).

[61] See n.6.

[62] Companies Act 1948, 11 & 12 Geo. 6, c. 38, s. 187(1). Cf Companies Act 1955 (N.Z.) s.188.

[63] Companies Act 1948 (U.K.), s. 188(1). Cf. Companies Act 1955 s. 189.

pulsory retirement of directors of public companies who reach the age of seventy but this provision is sanctionless and can be avoided by resolution in general meeting preceded by special notice.[64]

Second, there is the power of the Board of Trade to appoint an inspector to investigate the affairs of a company when it appears to the Board that there are circumstances suggesting that the officers of the company have been guilty of misfeasance or other misconduct toward its members.[65] Such an investigation is usually carried out by a Queen's Counsel or a chartered accountant. The investigator has power to require the production by any of the officers or agents of the company of books or documents relevant to the investigation and can require any of the officers concerned to appear before him and examine them on oath. Under the Companies Act 1967 the Board of Trade can now require the production of books and documents before an inspector is appointed.[66] The inspector reports to the Board at the conclusion of his investigation and the Board can bring civil proceedings in the company's name in any case where it appears that they ought to be brought in the public interest.[67] Thus the report is not a binding judgment but it is admissible in legal proceedings as evidence of the opinion of the inspector in respect of any matter it contains.

This approach does not appear to have resulted in any increase in litigation.[68] Its main weakness is that while it laudably seeks to detect mismanagement, it then casts the task of providing any remedy back to the courts with their traditional remedies which, as we have seen, are based on their unwillingness and lack of qualifications to deal with this problem.

[64] Ibid., s. 185.

[65] Ibid., s. 165(b)(ii) and Second Savoy Hotel Investigation, Report of June 14, 1954 (H.M.S.O.). The difficulty with this provision as worded is that the word "misfeasance" appears not to cover mere negligence; *Re B. Johnson & Co. (Builders) Ltd.* [1955] Ch. 634 (C.A.). That case dealt with the phrase "misfeasance or breach of trust" in s. 333(1), by a director of a company in the process of being wound up and it could, therefore, be argued that the wording of s. 165(b) invites a wider interpretation. See *Selangor United Rubber Estates Ltd.* v. *Cradock* [1967] 1 W.L.R. 1168, 1173-1174.

[66] Companies Act 1967, c.811, s.109.

[67] Ibid., s.37(1).

[68] In the United States the bringing of negligence suits against directors is increasing; *Wall Street Journal,* June 29, 1966. Two reasons cited for this trend are the growing use of the contingency fee in such cases and the greater availability, under the disclosure laws of corporate information on which to base a suit. New developments in federal securities law centered around Rule 10b-5 have also no doubt encouraged this trend. In New Zealand, by way of contrast, considerable procedural difficulties confront would be plaintiffs. As well as the absence of a derivative action s. 209 is unavailable where only negligence can be established; *Re Five Minute Car Wash Service Ltd.* (1966) 1 W.L.R. 745 and s. 321, which is similar to s. 165 of the English Companies Act, is limited to the context of a winding up.

PART 4—Proposals for the reformulation of the common law rule

(i) Where the directors ratify managerial recommendations

Even if the business judgment rule is justified when directors make independent decisions and establish long term policy, we are still faced with the issue of whether an ordinary standard of care should apply in the situation where the board rubber stamps a recommendation of the management put before it for approval. Should the law impose on directors in such a position a duty to conduct a "reasonable investigation" in the same way that section 11 of the United States Securities Act of 1933 imposes a duty, on directors and others involved in the preparation of a prospectus, to establish that they had after reasonable investigation, reasonable grounds to believe and did believe that the statements in the prospectus were true?[69] Under present law it appears that a director is generally entitled to rely on management having acted with due care unless he is actually aware of circumstances that would indicate that such was not in fact the case.[70] Should the law require him to act affirmatively, that is, codify his role of asking discerning questions, in the way the Court in *Escott* v. *Barchris Construction Corp.*[69] saw the Securities Act as requiring those who signed a prospectus and were directors of the corporation at the time it was filed with the S.E.C., being required to act? Should the law separate the responsibility of inside and outside directors at this point?

Barchris is instructive because it involved an analysis of the responsibility of both outside and inside directors for the accuracy of their company's prospectuses. In dealing with the responsibility of the two outside directors the Court found that having signed the prospectus and not having carried out any checks as to its accuracy these directors were liable despite the facts that one was a bank chairman and the other a civil engineer and that both had held their board positions for only a month prior to the filing of the prospectus with the Securities and Exchange Commission. Both had clearly acted in reliance upon the assurances of the corporation's officers that all was in order. As to a director who was the corporation's counsel and had actually taken part in the preparation of the prospectus the Court recognised that more could be expected of him than of his outsider colleagues and found him wanting too, according to the statutory standard.

Whatever the justifications for imposing such an obligation on the signatories of a prospectus to be issued to enlist public funds, it would seem that none of them are necessarily relevant to the ordinary situation of the board relying upon management. The *Barchris* Court itself seems to agree with this reasoning for in discussing the liability of underwriters as compared with that of directors under section 11, Mr Justice McLean pointed out that the directors expressly chose the executives to deal with the details of management. To that end they

[69] See *Escott* v. *Barchris Construction Corp.*, 283 F.Supp. 643 (1968).
[70] See text accompanying n.39.

were entitled to rely on management carrying out its responsibilities and did not need to investigate their every action. If such investigation were required by law then the purpose of having a board of directors at all separate from the management would be substantially undermined in the sense that the board would have less time to perform its independent functions.

The problem becomes one of ensuring that degrees of continuing supervision which lets management do its job effectively while simultaneously ensuring the detection of any serious mismanagement. The contemporary judicial standard demands nothing in the way of positive action on the part of management to this end. Any norm which is established must be to a large degree fashioned against the current practices of business as has been the case in the development of the liability in negligence of auditors and other professionals.[71] Mace and other students in this field detect a growing level of actual participation by directors in the executive functions of corporations. A desirable approach would be to assess the actual level of participation and require independent investigation in accordance with the extent of that participation. This was the approach taken by the Supreme Court of New York in *Syracuse Television, Inc.* v. *Channel 9, Syracuse, Inc.*[72]

Courts should now ask not only whether a director was actually aware of facts which would have put a reasonable man on inquiry but also whether, taking into account the extent of his participation in the management function, he should have become aware of facts which would have put a reasonable man on inquiry to investigate further?

(ii) Where the director gives independent advice

We are now left with the situation where a director takes on the task of giving independent advice to management. The advice given by the director will either be in his capacity as an expert in a particular field or in his capacity as a businessman drawing on his general experience and commercial skill. The problem here becomes one of drawing a line between responsibility for acts done in an ordinary professional role and acts performed in a role which is something less than that. In the latter situation the justifications examined above for the business judgment rule being the standard for independent decision making apply with equal force.

In the law of torts the standard of care to be imposed on professionals has always been a source of some difficulty for the courts.[73] Much of the problem stems from an attempt to impose a standard of skill and care in such cases which is related to generally accepted

[71] See e.g. *Pacific Acceptance Corporation* v. *Forsyth et. al,* (1970) 92 W.N. (N.S.W.) 29.

[72] 51 Misc. 2d 188, 273 N.Y.S. 2d 16 (1966).

[73] See Curran, "Professional Negligence — Some General Comments", 12 Van. L. Rev. 535 (1959).

standards within the profession rather than those of its most competent members. If the defendant has held himself out as being a member of a particular profession then a degree of specialized knowledge and skill will be demanded of him regardless of whether or not he possesses it. This standard is the general average of professionally acceptable conduct. Many American states even accept a lower standard based on the skill and training which is ordinarily possessed by those practising the profession in that particular community.[74] The problem remains, however, regardless of what standard is adopted, that neither a judge nor a jury can assess such conduct except on the basis of expert evidence from members of the very same profession. Thus in most cases the profession itself is largely the arbiter of its own legal standards. The business judgment rule, strictly applied, effectively prevents these difficulties arising in the case of the negligence of company directors.

In the decision of the House of Lords in *Hedley Byrne & Co. Ltd.* v. *Heller & Partners Ltd.*[75] a test is proposed which is exemplitive in that it purports to go across professional lines and cover a broad range of situations where legal responsibility might be imposed for negligent advice which results in economic loss.[76] In the course of his speech Lord Reid attempted to define what the House spoke of as the "special relationship" needed to give rise to a duty of care in such situations.[77] The decision of the House of Lord was subjected to careful analysis by the High Court of Australia in *M.L.C. Assurance Co.* v. *Evatt*[78] where the Court made it clear that the mere existence of a professional relationship was only one of the factors to be taken into account in establishing whether a "special relationship" exists. The High Court also widened the proximity needed before a duty of care could be imposed in dispensing with the requirement of knowledge of a particular transaction in which the advice or information was to be used and of the particular person who was going to act upon it. On appeal the Privy Council appears to have narrowed liability to cases where the defendant was in the business or profession of giving advice.[79]

It is suggested that two criteria could usefully be incorporated into the *Hedley Byrne* test to decide upon the existence of a duty of care in particular circumstances. These can be called the "subjectivity" and the "use of available information" factors. The first refers to the kind of judgment which must be exercised. If a situation is one on which a variety of opinions might be forthcoming as to what the correct decision would be then the court should be reticent in imposing an

[74] See Morris, "Customs and Negligence", 42 Colum. L. Rev. 1147 (1942).

[75] [1964] A.C. 465 (H.L.); [1963] 2 All E.R. 575.

[76] See e.g. Stevens *"Hedley Byrne* v. *Heller:* Judicial Creativity and Doctrinal Possibility" (1964) 27 Mod. L. Rev. 121; Goodhart, "Liability for Innocent but Negligent Misrepresentations, 74 Yale L.J. 286 (1964); Coote, "Effect of *Hedley Byrne,*" 2 (1967) N.Z.U.L.R. 263 (1967) and Kember, "Liability for Negligent Statements: Round Two", (1970) 5 V.U.W.L.R. 293.

[77] [1964] A.C. 465, 486; [1963] 2 All E.R. 575, 583.

[78] (1968) 42 A.L.J.R. 316.

[79] *Mutual Life & Citizens' Assurance Co. Ltd.* v. *Evatt* [1971] A.C. 793.

ordinary duty of care. The business judgment rule is perhaps the most striking example of such an instance. As we have already seen, ordinary business decisions are particularly subjective and the range of reasonable alternatives is often very wide. On the other hand, in cases where the situation calls for little exercise of discretion and is fairly clear cut the courts have more room to impose higher standards. The court will still be relying to a considerable extent on professional witnesses in deciding how much subjectivity was involved in the provision of a particular piece of advice but at least it will be doing so in the context of a model of its own design.

The "availability of information" factor is very closely related to the "subjectivity" factor. This refers to the extent to which facts were available to the person giving the advice upon which he could base his recommendation. If facts were scarce then the advice given must necessarily have been less reliable and the defendant should not be held to an ordinary standard of care. If facts were readily available then the defendant can be held responsible for the decision he made if he did so without adequately informing himself of those facts before making his decision.

Thus using the rule in *Hedley Byrne,* as modified in this manner, to establish the liability of company directors for advising management, we arrive at a situaiton where the director giving advice *qua* director, that is, in ordinary business situations, will do so without legal responsibility because of the subjectivity factor. Although a duty of care might exist under *Hedley Byrne* the standard of care and skill is a low one, having regard to the subjective nature of the advice being given and will not give rise to liability due to the business judgment rule. Conversely, if the decision is made on the basis of fully available data and there is an absence of subjectivity then a higher standard of care can be imposed. The advantage of such an approach is, first, that it reconciles the liability of company directors with that of other professionals and judges all of them by a similar standard which at the same time gives cognizance to the different character of decisions typically made by each. Second, it recognises that although most business decisions directors make are of a discretionary and subjective character there are situations (the expert outside director being the principal example) when the rationale of the business judgment rule is missing and there is no reason why a director should not be held responsible for the advice he gives simply because he is a director.

Two objections could be raised against the model of liability which has been developed. First, it might be said that if expert outside directors are made responsible for the advice they give as experts on the basis of an ordinary standard of care then they will be deterred from accepting positions on the boards of corporations. This might occur if their fees were established by legislation but as such is not presently the case, these should increase sufficiently to cover the risk of liability or the cost of insuring against it, where such indemnification is legal.[80] Once

[80] For a discussion of the law see Note, (1970) 16 McGill. L.J., 323, 379.

this happens such directors will be in exactly the same position as their professional colleagues who are not company directors.

The other objection is perhaps sounder. It concerns the vagueness and imprecision of the application of the suggested model of liability and argues that it would create undesirable uncertainty amongst directors as to what standard of care they would have to meet. It is submitted that this objection too is unfounded because most of the situations in which an ordinary standard of care would be imposed would be fairly obvious to the individual concerned. As an expert he would be only required to meet the same standard of care as other members of his profession. Further, the instances of an "objective" business decision are likely to be few indeed and probably manifest because of their rarity. To exclude liability in such cases through a reduced standard, however, would be no more legitimate than to enable the expert director to continue to avoid liability solely because of his corporate status.

In conclusion it is submitted that the business judgment rule should be formulated as follows:

(a) In cases of independent policy and other major corporate decisions company directors should be held to a standard of care which not only takes into account the business nature of the decision being made but also current good business practice.

(b) Where directors are merely ratifying the advice of their companies' management they should be entitled to rely on such advice unless put on inquiry, but regard should be had to the extent to which their participation in management should have made them aware of facts which might reasonably have led them to investigate further. Thus a higher standard of care should always exist in the case of inside directors.

(c) In cases of independent advice to management directors owe an ordinary standard of care and skill unless they are providing advice of a purely business nature and in determining the nature of the advice regard should be had to the availability of information on which to base the advice and the variety of conclusions which could have been made on the basis of that information.

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