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# Changing Perceptions into Reality : Fiduciary Standards to Match the American Directors' Monitoring Function

## **Abstract**

This paper describes the historical fiduciary obligations of the American outside director and contrasts those obligations with prevailing obligations in today's environment of the monitoring director. Special attention is devoted to the role of outside directors when their firm is the target of a takeover. In no other context are the demands on the outside director greater and more strain placed on the monitoring model than in the context of a corporate takeover. The final section of this paper examines the relief modern statutory provisions provide to the director and the monitoring function

## **Keywords**

outside directors, corporations, United States, role of directors, corporate law

# CHANGING PERCEPTIONS INTO REALITY: FIDUCIARY STANDARDS TO MATCH THE AMERICAN DIRECTORS' MONITORING FUNCTION

by

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## INTRODUCTION

There has been a dramatic change in the composition of the American boardroom over the past two decades. Although it remains white, Protestant, wealthy and Republican, it has taken on a distinctly new characteristic. Today, most board members of American public corporations are not financially dependent upon the company on whose board they serve. But, this was not always the case. One 1970 study found that 'outside' directors held 43.5% of the seats on 495 surveyed corporations' boards.<sup>1</sup> Most recently, outsiders now account for 72% of directors on public corporations.<sup>2</sup> The change reflects the vision that the function of the board of directors is to monitor the managers' stewardship of the firm.<sup>3</sup> This belief is in stark contrast with the older view that directors were 'super' managers chosen for their capacity to develop grand policy designs and to supervise their execution by the full-time managers. The inherent constraints on the outside director's time as well as the information reaching him assured that he could never function as a 'super' manager.<sup>4</sup> At the same time, there has been the recognition that a critical mass of outside directors could provide much needed discipline for the otherwise unsupervised managers. Scandals in the early 1970's growing out of the efforts of the Watergate Special Prosecutor (who unearthed extensive bribery of domestic and foreign government officials by American corporations) heightened the concern for boards of directors to serve as a watchdog.

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1 Smith, 'Interlocking Directorates Among the "Fortune 500"', *Antitrust L & Econ Rev*, Summer 1970 at 47 & Table 1.

2 Heidrick & Struggles, *The Changing Board 3* (1987).

3 See generally M A Eisenberg, *The Structure of the Corporation 159-168* (1976). The prescription for a monitoring board is carefully set forth in the on-going corporate governance project of the American Law Institute. See *Principles of the Corporate Governance: Analysis and Recommendations Part III* (TD No 2 1984).

4 The falacies of the older perceived view of director qua manager are revealed in Eisenberg, 'Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants' (1975) 63 *Cal L Rev* 375-403.

But the independence so obtained by the quest for outside directors may not have been more than skin deep. To be sure, the 'outside' directors who predominate on the boards of America's publicly traded corporations are not dependent upon that firm for their livelihood. Their principal income is derived from sources other than their boardroom fees. But their identity, cultural and psychological, is not much different from that of the managers they are to oversee.

Ninety-three percent of directors are college educated,<sup>5</sup> white males,<sup>6</sup> with a median age of 54,<sup>7</sup> and they are predominantly Protestant and Republican.<sup>8</sup> Indeed, the cultural identity among corporate directors is a source of wonder well documented in the literature.<sup>9</sup> That there is little to distinguish the typical outside director from the firm's managers whose stewardship the outside director monitors is evident from the fact that over seventy-five percent of corporate directors are themselves captains of industry or the close advisors to those who are.<sup>10</sup> Contributing to the cohesiveness of directors, inside as well as outside directors, is their association with one another. They are colleagues in the truest sense of the expression. Directors join with top management on a regular basis to share a common burden and obligation to advance the corporation's interests. To this task, they not surprisingly bring a unified view of the corporate interest. Studies repeatedly document that the leading criterion for selecting a board nominee is his probable identification with and acceptance of the company's goals and methods of operation.<sup>11</sup> Indeed, a director is expected not only to work within the group's collective views of the corporate interest, but also to cooperate with other board members, whether they are also managers or not, in reaching decisions by group consensus.<sup>12</sup> In the face of psychological and sociological forces such as these<sup>13</sup> one may have serious reservations of how well-equipped the outside director is to discharge his monitoring function. Outside directors are also bonded to the firm's chief executive officer through the active role he plays in their nomination to the board of directors. All director nominations and decisions to renominate a sitting director occur through a process that is dominated by the chief executive officer of the corporation on whose board the nominee will serve.<sup>14</sup> To be sure, all American directors must stand for election by the firm's stockholders.

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5 See Heidrick & Struggles, *Director Data 8* (1982).

6 See Heidrick & Struggles, *The Changing Board 3* (1987).

7 See Heidrick & Struggles, *Director Data 7* (1982).

8 See Heidrick & Struggles, *Director Data 8* (1980).

9 See eg G Domhoff, *Who Rules America?* (1967); T Dye, *Who's Runing America?* (1976) and F Hunter, *Top Leadership Cohesiveness* (1974).

10 See Heidrick & Struggles, *Director Data* (1980).

11 See eg J Bacon & J Brown, *Corporate Directorship Practice: Role, Selection and Legal Status of the Board 30* (1975).

12 See eg M Mace, *Directors: Myth or Reality 97-101* (1971).

13 For an expanded analysis of the social and psychological forces that can deflect the outside director from being an aggressive monitor of management, see Cox and Munsinger, 'Bias in the Boardroom: Psychological Foundation and Legal Implications of Corporate Cohesion' (1985) 48 L and Contemp Prob 83.

14 In a significant percentage of nominating committees, the chief executive officer chairs the nominating committee. Heidrick & Struggles, *The Changing Board 4* (1983). Even when the nominating committee is staffed entirely by outsiders, the chief executive attends their meetings. Perham, 'The Men Who Pick the Board', 112 Duns Rev, Dec 1978 at 57. In any case, new nominees are advanced only when they are believed acceptable to top management. Id, at 57-58.

That ritual, however, rarely exposes the director to hostility; in practice nomination foreordains the outside director's election. Therefore, the outside director legitimately feels disposed to the firm's chief executive officer as natural gratitude for his support in obtaining membership to the board of directors.

A further force impacting the capacity of the outside director are the intense demands on their time from their major vocation; the time devoted to their directorial responsibilities is necessarily constricted. This is not true of the 'inside' director, but their function within the boardroom hardly can be expected to conflict with the agenda and activities developed by them as members of management. Accordingly, the inside director has never had a vital role in the on-going American debate on corporate governance. The emphasis has been on the outside director.

Despite the substantial social, psychological, cultural and practical forces that pose natural impediments to the outside director being a consistent detached watchdog of management's stewardship, important legal institutions have now evolved from the perception that outside directors can serve as monitors of the firm's managers. For example, the imprimatur of the outside directors overcomes serious conflict of interest concerns when managers enter into transactions with their corporations. Outside directors are also relied upon as a useful body to investigate charges of managerial misbehaviour.

This paper describes the historical fiduciary obligations of the American outside director and contrasts those obligations with prevailing obligations in today's environment of the monitoring director. Special attention is devoted to the role of outside directors when their firm is the target of a takeover. In no other context are the demands on the outside director greater and more strain placed on the monitoring model than in the context of a corporate takeover. The final section of this paper examines the relief modern statutory provisions provide to the director and the monitoring function.

## Historical Context of Director Obligations

The monitoring obligation of outside directors is not a recent phenomenon. Consider the early case of *Barnes v Andrews*,<sup>15</sup> where the court held that Andrews, an outside director, whose tenure was less than 9 months, had breached his duty to inform himself adequately about the newly created company's operations. The corporation had raised a substantial amount of capital through a public offering, possessed a well-equipped and staffed factory, and produced sufficient parts for its end product, starter motors; nevertheless the firm encountered dramatic delays in the assembly of starter motors and ultimately failed. The court held that Andrews breached his duty by failing to inform himself adequately about the firm's performance and position. There was no evidence that Andrews had made even the most minimal inquiry during his tenure of the company's performance or financial position. The holding in *Barnes* is sharpened by the absence of any facts or circumstances known to Andrews imparting notice to him that the firm was experiencing problems. The duty imposed by *Barnes*, therefore, is more demanding than the typical case in which

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15 298 f 2d 614 (SDNY 1924).

the director has failed to respond reasonably to warnings that would have prompted a reasonable director to action.<sup>16</sup> Moreover, *Barnes* is more demanding than those cases punishing directors who are habitually absent from board meetings.<sup>17</sup>

But today's concern for the monitoring director involve problems far more subtle than posed in *Barnes*. The concern today is not why the firm failed financially during the outside director's watch; the prevalent question today is the extent of the outside director's obligation to militate the company's violation of federal and state directives against pollution, employment discrimination, bribery, and unfair competition. On questions such as these, the burden of inquiry, if it is to be imposed at all, is far more encompassing and demanding than *Barnes* imposed upon Andrews.

The only American decision on this question is *Graham v Allis Chalmers Manufacturing Company*.<sup>18</sup> A derivative suit was brought against the directors of Allis Chalmers to recover damages the company suffered because its employees engaged in massive bid rigging with competitors in flagrant violation of the American antitrust laws. One theory of the plaintiff's action was that the directors had acted unreasonably in failing to establish a system to detect and prevent antitrust violations by company employees. This theory found support in the fact that nineteen years earlier Allis Chalmers had entered into two consent decrees with government regulators settling claims of price fixing. The plaintiff argued that the consent decrees put the current board members on notice so that they had a duty 'to ferret out such activity and to take active steps to insure that it would not be repeated'.<sup>19</sup> The Delaware Supreme Court dismissed the action, reasoning that Allis Chalmers was a large multinational company with over 30,000 employees. The court reasoned that it was not reasonable to consider that the directors would undertake an active investigation of each division of the firm. The court held the directors acted reasonably in relying upon the reports and summaries of operations which they had no reason to believe untrustworthy. More importantly, the court believed the directors had no duty to establish and maintain a 'law compliance' program. The court observed that such a system of surveillance was required only if the board had 'suspicions' of wrongdoing.<sup>20</sup>

If the board is perceived as a body of super managers, rather than monitors of those who manage, the reasoning in *Graham* is more understandable. As a manager and policymaker, delegation is not only desirable, but essential. Any other approach is not practicable in light of the limits on the outside directors' time, information, and acuity to the problems at hand. But with the current recognised role of outside directors as a monitor of the managers' stewardship of the firm, *Graham* causes

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16 In the leading case, *Bates v Dresser* 251 US 524 (1920), Justice Holmes held that a teller's flashy lifestyle should have prompted the bank's president to inquire whether shrinkages in the bank's deposits were the result of the teller's embezzlements, which they were. However, the bank's directors, not being similarly on notice were held not to have breached their fiduciary duties.

17 See eg *Bowerman v Hamner*, Receiver, 250 US 504 (1919) (Director had not attended board meetings for 5 years held to have breached duty to inform himself).

18 41 Del Ch 78, 18 A2d 125 (Sup Ct 1963).

19 *Id.*, 129.

20 *Id.*, 130.

concern whether it continues to be good authority in today's world. *Graham's* reasoning is inconsistent with the more recent decision in *Francis v United Jersey Bank*,<sup>21</sup> where the court was unwilling to allow a director to hide behind a veil of ignorance—the very defense upheld in *Graham*:

Directors are under a continuing obligation to keep informed about the activities of the corporation . . . . Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect . . . . Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.<sup>22</sup>

The difference between *Graham* and *Francis* is their placement in time. *Francis* was decided two decades after *Graham* during which time the received model of the outside director had evolved from that of being an active manager to that of an active monitor. Moreover, there has developed since *Graham* a solid perception that the public corporation's board of directors should design and implement legal compliance systems such as those argued for by the plaintiff in *Graham*.<sup>23</sup> Because the content of the law is informed by prevailing practices, there is good reason to believe that the Allis Chalmers board would today be pressed to justify the absence of any compliance procedures,<sup>24</sup> especially in view that the prevailing legal climate emphasises the monitoring function of outside directors.<sup>25</sup>

Any doubt about the role the Delaware Supreme Court has cast the outside director in is removed by its landmark decision in *Smith v Van Gorkum*,<sup>26</sup> where the court held the outside directors breached their duty of care in approving the sale of Trans Union Corporation to Mr Jay Pritzker for \$55 per share. Trans Union was a publicly traded firm engaged primarily in leasing rail cars. In the course of its operations,

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21 87 NJ 15, 432 A2d 814 (1981).

22 87 NJ at 31-32, 432 A2d at 814.

23 See eg American Bar Association, Section on Corporation, Banking and Business Law, Committee on Corporate Laws, Corporate Director's Guidebook, (1978) 33 Bus Law 1591, 1610 and Statement of Position Concerning the Role of Corporate Directors of the Business Roundtable (1978) 33 Bus Law 2083 at 2101.

24 Two leading Delaware practitioners have persuasively reasoned that *Graham* would be decided differently today because of the changed perspective of the role of outside directors. See Veasey & Manning, 'Codified Standard—Safeharbor or Unchartered Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law' (1980) 35 Bus Law 919, 930 & n 53. But see Ward, 'Fiduciary Standards Applicable to Officers and Directors and the Business Judgment Rule under Delaware Law' (1978) 3 Del J Corp Law 244, 246-47 (reasoning that decision to install compliance procedures is akin to an economic decision depending primarily upon the level of notice and risk of harm. This reasoning appears to overlook cases such as *Barnes* and *Francis* that found a breach of the director's duty even though the director was not on inquiry notice).

25 This does not mean, however, that the directors in either *Graham* or *Barnes* would today be liable for their subordinate's misbehaviour. Even reasonably designed and superintended compliance programs will not detect or deter all misbehaviour. The directors' technical breach in failing to install such a system may ultimately bear no causal relationship with the harm caused by the subordinate's wrongdoing. Even though Andrews breached his duty to inform himself, the court ultimately held he was not liable because there was no evidence that had he inquired he could have prevented the company's failure.

26 488 A2d 858 (Del Sup Ct 1985).

Trans Union generated large amounts of cash and profits, and more importantly, accumulated millions of dollars in investment tax credits that it could not itself use to reduce its income tax liability. Trans Union's large backlog of investment credits held great value to any firm acquiring Trans Union as the credits could be used by the acquiring firm to reduce its tax obligations. While considering how best to employ the accumulated tax credits, management also studied the possibility of a management buyout of the firm. Donald Romans, chief financial officer, estimated that the cash generated by Trans Union's on-going operation would justify a management buyout price of \$50-\$60 per share; Trans Union shares were then trading for \$38 per share.

Armed with this information, Jerome W Van Gorkum, Trans Union's chief executive officer, asked Pritzker if he was interested in buying Trans Union for \$55 per share. Pritzker agreed to the price. At a board meeting called with only one day's notice, Pritzker's 'take it or leave it' offer to purchase Trans Union at \$55 per share was presented by Van Gorkum to the board. The meeting lasted barely two hours, the presentation was completely oral, no written drafts of the agreement were circulated, and Van Gorkum did not disclose that the \$55 figure reflected the price Trans Union's own cash flow would justify if the purchase were a management buyout. The board was never told, and it never inquired, what price a third party (who could use the Trans Union's accumulated tax credits) would pay for Trans Union and its underutilised tax credits. The board's behaviour through its consideration of the sale can best be described as an uncritical acceptance of senior management's recommendations.

The Delaware Supreme Court held that the directors failed to inform themselves adequately on the decision before them and, therefore, acted with gross negligence in approving Trans Union's sale. The court chastised the directors for failing to inquire as to the basis upon which the sale price was determined or, for that matter, informing themselves as to the intrinsic value of the firm. Certainly monitoring requires on such a fundamental decision an aggressive probing of management's reasoning in support of the proposal submitted to the board. This in fact is what the Delaware Supreme Court demanded, minimally, of the directors.

### **Strain and Growth in the Duty to Monitor**

The ability of American outside directors to act as an independent monitor of the firm's managers undergoes its most severe test in contests for corporate control. Certainly when there is a hostile bid for the firm, there are no natural psychological forces that can be expected to drive the outside directors from their manager's side. Their prior associations, shared experiences and aspirations, and continuing nonpecuniary awards if the firm remains independent, in combination, cause outside directors to regard the bid as a threat. One need only reflect on how frequently the board's response to an outside bid is to assume a siege mentality and instinctively 'circle wagons'. The initiation of an outside bid repeatedly results in a 'we-they' attitude between the incumbent directors and the unwanted suitor.

As we are aware, the takeover movement that began more than two decades ago continues to gather momentum. The number and dollar



amounts involved in hostile takeovers continue to grow. The targets to takeovers, however, are not without weapons for their own defense. Indeed, one marvels at the creativity and resourcefulness of skillful takeover lawyers. It is the implementation of these defenses that puts the independent director's monitoring role to its greatest test.

Once again, and not surprisingly, it is Delaware that has weighed into the fray and it is its decisions that have had the most dramatic impact on melding the outside director's performance to the prevailing perception that they are the monitors of managers. *Unocal Corp v Mesa Petroleum Co*,<sup>27</sup> held that the board of directors has the burden of proving it acted in good faith and only after reasonable investigation when it initiated a defensive manoeuvre. Importantly, *Unocal* also imposes the demanding requirement that the defensive manoeuvre 'must be reasonable in relation to the threat the outside bidder or its bid posed'.<sup>28</sup>

In both its locus of the burden of proof upon the directors to establish their good faith and the reasonableness of their investigation, as well as the requirement that the defensive manoeuvre not be disproportional, the Delaware Supreme Court has changed dramatically the areas of inquiry in takeover contests. No longer is it permissible for the target board to 'wage war at any price' once they have isolated a difference in business policy or practices between the incumbent board and the suitor for control.<sup>29</sup> And no longer do the directors enter the legal fray with a heady presumption of infallibility—they have the burden of persuasion under *Unocal*.

This long step in evolving doctrine is based on the courts' awareness that contests for control pose an inherent conflict of interest to the managers and outside directors. So conflicted, the directors should not enjoy the presumption of propriety and deference that attends their other decisions. Interestingly, the court, instead of rendering the board totally incapable, has chosen the middle position of altering the burden in justifying their actions. Not surprisingly, great emphasis is placed in these inquiries upon the role and actions of the outside directors. In effect, the American courts have determined that the outside directors can and should play an important role in refereeing contests for control.

In *Hanson Trust PLC v SCM Acquisition Inc*<sup>30</sup> the court reasoned that the outside directors have a special function to serve when asked by self-interested management to adopt a defensive manoeuvre. The court envisions that the outside directors must take some steps to independently assure that the proposed transaction is fair. In the process, the court suggests they distance themselves from management. Such steps can include securing their own advisors and constituting themselves as an

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27 493 A2d 946 (Del 1985).

28 *Id.*, at 955. The Second Circuit Court of Appeals expressed a more rigorous standard of requiring an *independent* non-takeover driven basis to justify defensive maneuvers in which the target corporation transferred shares to its wholly owned subsidiary and a smaller block of shares to a newly created employee stock ownership plan. See *Norlin Corp v Rooney Pace, Inc*, 744 F2d 255 (2d Cir 1984).

29 Contrast *Cheff v Mathes* 199 A2d 548 (Del 1964) where sweeping defensive maneuvers allowed where after a very skanty investigation board learned that bidder would change target's marketing practices, had liquidated a few companies he controlled, and may not have been successful in managing companies he acquired.

30 781 F2d 264 (2d Cir 1986).

independent negotiating committee to deal with their managers. At a minimum, *Hanson Trust* requires outside directors to disabuse themselves of thinking their's and the stockholders' interests are identical to those of the managers. In sum, monitoring requires the outside directors to assume an adversarial role vis-a-vis the firm's managers.<sup>31</sup>

Delaware has added an important second dimension to the monitoring role of outside directors in contests for control. As seen, the *Unocal* standard regulates the propriety of defensive manoeuvres. *Revlon Inc v MacAndrews & Forbes Holding*,<sup>32</sup> holds that at some point outside directors must cast aside their defensive aspirations and assume an entirely new role, that of a proactive auctioneer of the firm to the highest bidder.

In June 1985, Pantry Pride began its attempt to acquire Revlon with a casual proposal to Revlon's board of a price in the \$40-\$50 range per share. Rebuffed by Revlon's board, Pantry Pride initiated a hostile tender offer, initially bidding \$47.50, per share, then increasing its bid to \$50, and on October 7th raising it again to \$56.25. In early October, Revlon's board received offers from two potential white knights. The board ultimately accepted the bid by Forstmann, Little & Co (Forstmann) involving a buyout that would permit some management participation. Pantry Pride was undeterred by the preferential treatment Revlon's board continued to extend to Forstman and continued to raise its bid so that it would narrowly exceed the Forstmann offer. On October 12th, Forstmann made a new offer of \$57.25 per share conditioned upon, among other matters, the Revlon board granting Forstmann the option to purchase its Vision Care and National Health Laboratories divisions for \$525 million, a price approximately \$100-\$175 million below their appraised value. Rather than focusing upon the process by which Revlon's board determined the price at which to option these two divisions, the court challenged the board's ability at this stage of the contest to engage in any defensive manoeuvre whatever:

When Pantry Pride increased its offer to \$50 per share, and then to \$53, it became apparent to all that the break-up of the company was inevitable . . . . The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximisation of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards . . . . The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.<sup>33</sup>

The court enjoined the lock-up options because they destroyed further bids for Revlon and the options did not result in a higher price for Revlon. The Delaware Supreme Court has since emphasised that the

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31 A lock-up was upheld in *Cottle v Storer Communication Inc*, 849 F2d 570 (11th Cir 1988), after the court satisfied itself that the directors had negotiated in good faith with the suitors and granted the option of the assets after satisfying themselves that the option price was a fair one and that they had received the best offer.

32 506 A2d 173 (Del 1986).

33 506 A2d at 182.

directors' role as auctioneers only arises when it appears that the firm will no longer be independent because its 'sale' is inevitable.<sup>34</sup>

Any doubt regarding the Delaware Supreme Court's devotion to its newly established 'outside director as auctioneer' paradigm is removed by its recent decision in *Mills Acquisition Co v Macmillan, Inc.*<sup>35</sup> *Mills* held that the outside directors had breached their fiduciary duty by favouring in their negotiations the bidder preferred by management over Macmillan and also failing to establish enough independence from management so as to evaluate each bid and to determine whether further negotiations would yield a higher bid. To be sure, the outside directors are not compelled to accept the bid that merely offers the highest price. Rather their duty under *Revlon* is to obtain the best available transaction for the shareholders. Hence, directors may reject an offer for 42% of the shares at \$70 cash per share with the balance of the shares to be acquired for preferred stock to be valued at \$70 per share, in favour of a \$66 cash bid for all the shares.<sup>36</sup> Furthermore, *Revlon* has been interpreted as not barring the outside directors from favouring one suitor over another in the negotiations and arrangements preceding a bid.<sup>37</sup> The Delaware Chancellor has reasoned that *Revlon* does not compel the outside directors to preserve a level playing field; they may act to 'tilt' the field if they do so for the reasonable and good faith purpose of securing a better transaction for the stockholders.

Even though outside directors are not natural allies to the notion that the bids of outsiders should be dispassionately regarded or that they should eschew the advice of managers when the firm is under siege, the courts have announced standards that casts outside directors in this role. To be sure, takeover defenses and management buy-outs have struck many as getting out of hand so that one certainly could have expected some change in judicial attitudes in response to these phenomena. What is significant is not that the response has come, but that the courts have chosen the outside directors to shoulder the all important burden of protecting the stockholders' interests. And the role so imposed, while proactive, nevertheless is one that throughout is consistent with their overall duty to monitor managers. The following section of this paper examines whether recent legislative initiatives in Delaware and a majority of the states are inconsistent with the monitoring function of directors.

### Charter Limits on Director Liability

In the summer of 1986, the Delaware legislature amended its General Corporation Law to allow the charters of Delaware corporations to include provisions that limit director liability for damages arising from a breach

34 The Delaware Supreme Court has expressed the view that the 'auctioneer' paradigm applies when the sale takes the form of an 'active' action, management buyout or a restructuring plan. See *Mills Acquisition Co v Macmillan Inc* 559 A2d 1261 (Del 1989). It does not apply, however, in a parent-subsidiary cash out merger. *Bershad v Curtiss-Wright Corp*, 535A2d 840 (Del Supr 1987). Currently before the Delaware courts in the on-going Paramount-Time-Warner litigation is whether a friendly merger accompanied by a hostile bid from a third suitor, Paramount, should be examined under *Revlon* or *Unocal*.

35 559 A2d 1261 (Del 1989).

36 See *Citron v Fairchild Camera and Instrument Cor* Current Fed Sec L Rep (CCH) 93,915 (Del Ch 1988).

37 See In *Re J P Stevens & Co, Inc Shareholder Litigation*, 542 A2d 770 (Del Ch 1988).

of their duty of care.<sup>38</sup> Since Delaware enacted its statute, there has been an avalanche of similar statutory provisions in sister states.<sup>39</sup> The twin impetus for such legislative activity are the case decisions subjecting outside director judgments to closer scrutiny, such as *Smith v Van Gorkum*, and the so-called 'liability insurance crisis'. The latter refers to the unavailability of unlimited amounts of directors and officers insurance. Numerous carriers have found this type of insurance was an undesirable product because of the great actuarial problems they pose as well as the uncertain litigation environment. As a consequence, legislatures were sympathetic to the plea that without their action public corporations could no longer retain or attract high quality outside directors. The legislatures have thus exempted outside directors for any personal liability for lapses in their duty of care; managers who also serve on their company's board retain their individual liability for breaches committed in a capacity other than that as a director. It is therefore possible to view such legislative provisions as restoring the outside director to the position he enjoyed when low cost, high coverage insurance was bountiful: the outside director in that environment was not personally at risk, except for a nominal deductible amount, for any losses from his gross negligence. There is one important difference, however. Most such charter provisions completely immunise the outside director from any liability, whereas under the insurance policy the director had some exposure, usually up to \$25,000 or \$50,000, the policy's deductible amount. Because the effect of such charter provisions is to shield the director from the modest penalties he previously was exposed to under policies that subjected him to liability within the deductible limits, many have seen this as a major retreat from director responsibilities and the evolving role for the monitoring director.<sup>40</sup> The following sets forth this author's belief that such charter provisions can be expected to heighten, rather than diminish, the monitoring role of the outside director.

It is likely that charter limits on director liability will not reduce the frequency of challenges to director decisions or the standards for their scrutiny. To be sure, charter provisions will reduce, if not eliminate, the incidence of outside directors being held personally liable for their misguided judgments. However, in the face of such a charter provision, the litigant's focus will be upon the transaction itself. For example, if Trans Union had such a charter provision, the plaintiff in that suit could have been equally successful to seek an order asking the court to submit the transaction to the board of directors and stockholders for reapproval. There is every reason to believe that rather than risk the uncertainty of this process, which may have attracted a second suitor, Mr Pritzker would have settled the action, much along the lines of his actual settlement of the case, by increasing the price he was willing to pay. And, of course, the insurance company's exposure continues because of the prominent role played by inside directors, such as Van Gorkum, who are not

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38 Del Code Ann 102(b) (7) (Michie 1986).

39 For a description of the various legislative patterns and some of their interpretative problems, see DeMott, 'Limiting Directors' Liability' (1988) 66 Wash ULQ 295-317.

40 Interestingly, the state of Virginia 'caps' the amount a director can be liable to the greater of \$100,000 or the director's cash compensation during the preceding 12 months. Va Code Ann 13.1-692.1(a) (Supp 1987).

shielded by the charter provision for lapses committed in a nondirectorial capacity. Because the effect of a charter provision is to focus attention upon the transaction itself, rather than the personal liability of outsiders, courts can proceed with their scrutiny of the transaction without fearing their remedy will be draconian to the individual director. Indeed, those who have championed the heightened role of courts in protecting stockholder interests have suggested that limits on director liability are necessary. In an environment without limits, courts can find a breach only by imposing what oftentimes is a disproportionate sanction upon the director. Thus, courts may become even more demanding in the standards brought to bear on transactions requiring the directors' approval. If this occurs, it will be a phenomenon not unobserved by the plaintiff's bar who can be expected to become more active as standards for director conduct arise. The irony of charter provisions such as adopted in Delaware, therefore, is that it may actually stimulate an increase in the amount of litigation questioning director judgments.

Eliminating damage recoveries does not erode the incentive for care-based suits. The contingency suit, peculiar to America, is the major medium for enforcing officer and director obligations. While at one time the attorney could recover his fees in a successful suit, only if that suit produced a monetary recovery, today most fee awards occur because the suit resulted in a nonpecuniary benefit.<sup>41</sup> Thus a suit that established a technical breach of the directors' fiduciary duty and resulted in that decision's reconsideration, justifies the award of attorneys fees to the plaintiff's lawyer. In sum, the plaintiff's bar may be a most tangible beneficiary of charter limits on liability. It remains to be seen, however, whether such charter provisions will in fact hasten the demands on the outside director. Certainly, by immunising such directors from liability, there is no reason to believe that the momentum behind the obligations of outside directors to monitor will in anyway be slowed because of such charter provisions.

### **Speculations on Evolution of Australian Director Duties**

It is safe to say that the above described evolution of the obligations of American outside director is unique among common law countries. The American experience is a rich one, but that is only because it has been a troubled one shaped by cases raising hard issues in the context of public concern over the shocking scale of bribery of public officials, catastrophic damage to the public through violation of environmental, safety or antitrust laws, or today's takeover battles. Truly the past 25 years have been a time of growth and refinement in American corporate law. But it has not frequently been a time to rejoice in the performance of the American corporation or its outside directors. It is no surprise, therefore, that this brief period of time has brought a significant change in the obligations of American outside directors.

The legal demands upon Australia's outside directors are in the same tortured state that American case law was prior to the landmark decision by the Delaware Supreme Court in *Unocal*. Absent inquiry notice,

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<sup>41</sup> Coffee, 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class Action and Derivative Actions', (1986) 86 Colum L Rev 669.

Australian outside directors have no affirmative duties at this point to initiate surveillance programs to assure their subordinates are complying with the law. To be sure, the Australian law relies upon the outside director to serve as a sentry whose duty it is to protect the stockholders from the darkness of managerial overreaching. But in the most critical area of self-interest, the defense to a takeover, the mild confusion in the Australian case law suggests a groping for a better approach. At this time, the indications are that Australian courts will not choose to involve themselves as extensively as their American counterparts have in judging the propriety of defensive manoeuvres.

The touchstone for the duties of directors in the face of a hostile takeover is *Howard Smith Ltd v Ampol Petroleum Ltd*,<sup>42</sup> a case appealed from New South Wales. The directors of the target corporation issued a large block of shares to the party whose bid the board preferred. The effect was to destroy the majority position of the unwanted suitor, because the target's board believed that suitor's price was too low. Later the preferred bidder topped the price offered by the unwanted suitor. The judicial committee, however, did not resolve the case on the same fiduciary principles that guide American cases in such situations. Indeed, its argument was a constitutional one based upon the limits of director discretion embodied in the division of power between directors and shareholders. It held it was improper for the directors to use their powers to allot shares 'purely for the purpose of destroying an existing majority, or creating a new majority . . .'.<sup>43</sup> The panel reasoned that the departure from the directors' fiduciary obligations increased if it appeared that the ulterior purpose of the share issuance was to enable an offer for shares to proceed that the existing majority was in a position to block.<sup>44</sup> In sum, the directors' action in *Howard Smith* had violated the right of the existing majority to determine 'the right to dispose of shares at a given price'.<sup>45</sup> In contrast, the *Unocal* standard would have permitted a totally discriminatory defensive manoeuvre because the court was satisfied it was undertaken to secure a better offer. In this respect, *Howard Smith* is more rigid than the prevailing American case law; unquestioned obeisance to *Howard Smith* in fact can thwart well-meaning efforts of the target board to secure a higher price for control.

*Pine Vale Investment Ltd v McDonnell & East Ltd*<sup>46</sup> does not raise the constitutional concerns that dominated the thinking of *Howard Smith*, but focuses upon the motivation of the directors. Pine Vale controlled 26% of McDonnell and East and had announced its bid for a partial takeover of McDonnell. Before Pine Vale's formal offer was made, McDonnell issued rights to acquire additional McDonnell shares to all of its shareholders to raise funds to acquire another business. The effect of this was to raise the total cost of Pine Vale partial bid because more shares were outstanding and McDonnell's total value would increase due to the value of the acquired assets. Pine Vale's application for an injunction was rejected upon a finding that McDonnell's directors genuinely believed their acquisition was in the best interest of the company. To

42 [1974] AC 821 (PC).

43 Ibid, 837.

44 Ibid, 837-38.

45 Ibid.

46 (1983) 9 ACLR 19, 1 ACLC 1294.

be observed, all McDonnell stockholders were treated and affected equally under the transaction; Pine Vale's ownership percentage was not treated in a discriminatory fashion, as occurred in *Howard Smith*, because the offer was equally available to all stockholders. This factor not only distinguishes *Pine Vale* from *Howard Smith*, but also suggests why the case was decided on the more orthodox fiduciary concerns of purpose rather than rigid 'constitutional' concerns. In contrast, *Unocal* permitted discriminatory treatment of an unwanted suitor.

The High Court in *Whitehouse v Carlton Hotel Proprietary Ltd*<sup>47</sup> resolved whether an allotment of shares to the governing director's sons to ensure that control did not pass to his former wife and their daughters by focusing upon the transaction's purpose. The majority reasoned that the propriety of such transactions cannot be decided merely upon proof that a permissible purpose was the dominant motive of the transaction. The inquiry should rest upon whether but for the impermissible purpose the power would not have been exercised.<sup>48</sup> This position was later applied in *Darvall v North Sydney Brick & Tile Co. Ltd*.<sup>49</sup> The court emphasised that when the action of directors has a number of substantial purposes, one of which is impermissible, their action may be set aside even though the impermissible purpose was not the dominant one, provided it is established that the impermissible motive is causative in the sense that but for its presence the directors would never have taken the action. To the outside observer, the distinction the court attempts to draw between a dominant motive and one that is causative is purely semantic. Certainly the motive that leads the board to undertake a transaction they would not have undertaken "but for" the impermissible motive cannot be seen as other than the one that ultimately dominated the board's decision. In *Darvall* the target of a takeover responded to the bid by entering into a joint venture agreement to develop an important asset in conjunction with a cash offer for its shares. *Darvall* held that although the board of directors would not have entered into a joint venture agreement if the firm were not the target of a takeover, their entering into the agreement would not be enjoined. The court found that the directors' purpose was not to defeat the first bid, but to provide the shareholders with an alternative to that bid. Importantly, *Darvall* stressed that the directors' action may be undertaken for the purpose of demonstrating to the stockholders that it is not in their best interest to accept the hostile bid so long as there is a valid commercial interest underlying the transaction. As such, *Darvall* appears far more important not for its resolution of the murky question of causation, but rather what constitutes an 'impermissible motive'. The quest to secure a better bid in *Darvall* can be seen as not an impermissible motive that tainted the board's decision. If so viewed, *Darvall* is inconsistent with *Howard Smith* and more clearly in line with *Unocal* and *Revlon* approaches.

Absent from the Australian case law is the activism that so characterises the eagerness of American courts to both weigh the defensive manoeuvre's proportionality under the *Unocal* standard and to enforce the auctioneer's role upon the directors under *Revlon*. Nevertheless the Australian courts

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47 [1986-7] 162 CLR 285.

48 *Ibid*, 294.

49 (1988) 12 ACLR 537.

appear posed to look beyond a purpose requirement and perhaps are doing so already. *Pine Vale* and *Darvall* are not inconsistent with the results reached under the American cases for each were undertaken to secure a higher price for their shareholders. Even *Unocal* supported a successful defensive manoeuvre because it provided a higher price for the stockholders. It remains to be seen whether *Howard Smith* is a relic to be ignored by the Australian courts; it can, however, be isolated to its facts so that it stands for no more than that it is a disproportionate response to reduce one's position from being in control to merely a substantial minority stockholder.

What will bring Australian cases more fully into line with American cases is a sweeping definition of the role of directors and a discreet articulation of what circumstances cause that role to change. It may well be that this will never occur and this may well not be due to the culture of the Australian courts. An important limitation on the evolution of directors' duties in takeovers is the highly textured regulatory regime for takeovers in Australia. Pills, lock-ups, spin-offs, to mention just a few of the devices that so frequently appear in American takeover battles, are not easily implemented within the tight proscriptions of Australia's company and securities laws.<sup>50</sup> Thus, the shocking defensive manoeuvres that have stimulated the development of duties for America's outside directors may well never present themselves to an Australian court. Absent such stimuli, American case law may well not have moved away from the all-consuming importance of the board's purpose for a transaction and evolved the prevailing referee and auctioneer roles for the outside directors.

## Conclusion

The revolution within the American boardroom that began over a quarter of a century ago is still occurring. The decisions in the last few years have imposed duties upon outside directors that could not be imagined even ten years ago. This revolution is fed by the perception that outside directors are neither managers nor shut-eyed sentries. The courts have shaped duties for the outside directors' consistent with the received view that outside directors can serve a monitoring function. Through judicial intervention in cases such as *Smith*, *Unocal* and *Revlon* the message to the American boardroom is quite simple: the outside directors must serve a proactive monitoring function otherwise corporate transactions are at risk of being judicially disturbed. Throughout it all, the law reflects its wonderful talent to complement societal perceptions when moulding rules for current day problems. The role of the monitoring director in American companies is now well known; whether it will be received in Australia or other countries will depend not just on that perception, but other cultural influences, for example the strength of other regulatory devices such as the specific directives in the companies and securities codes.

<sup>50</sup> See generally DeMott, 'Comparative Dimensions of Takeover Regulation' (1987) 65 Wash ULQ 69, 114-16 (Finding that 1980 takeover legislation seriously constrains power of target company to defend itself vis-a-vis the latitude enjoyed by American and Canadian targets).



The Australian takeover and control cases reflect the early signs of development similar to those that occurred in America in the 1970's. We are at the early stages of that change and in a legal culture that reflects none of the broad public rejection of the boardroom orthodoxy which rejection led to the 'greening' of the American boardroom. Moreover, the Australian companies and securities laws do not accord Australian boards the broad powers their American counterparts enjoy in devising various defensive and restructuring plans. Australia, therefore, may well not have the same need to restrain abuses in power through the evolution of demanding standards for outside directors as has been necessary in America. The recent decisions in *Pine Vale* and *Darvall* nevertheless reassure us that the Australian courts are not inflexible in their consideration of the relationship of results to duty. It may well be that given the right force of circumstances that the Australian courts may be as instrumental as their American counterparts in shaping the mission of the outside director.