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COMMENTS

DIRECTOR LIABILITY UNDER THE BUSINESS JUDGMENT RULE: FACT OR FICTION?

by Michele Healy Ubelaker

UNDER the business judgment rule a corporate director who acts in good faith and without corrupt motive will not be held liable for mistakes of business judgment that damage corporate interests.¹ The rule represents, in part, a judicial reluctance to interfere with the internal affairs of a corporation. In *Evans v. Armour & Co.*² a federal district court articulated the rationale of the business judgment rule:

[W]hen the law has occasion to inquire into [directors' activities] it is not to substitute its judgment as to whether one offer is better than another, or to resolve disagreements as to how the future business pattern of the corporation should proceed, but rather to determine if the directors have acted soundly and in accord with accepted business practices.³

While this justification of the business judgment rule indicates that a director must act in the best interest of his corporation, the failure to define the parameters of the business judgment defense precisely substantially stifles any attempt to quantify the degree of care that a director owes to his corporation. The failure to confront issues of negligence and due care may reflect the considerable confusion that exists as to which functions directors, particularly outside directors, must fulfill in managing corporate affairs.⁴ The lack of clarity that typifies the judicial treatment of a director's legal accountability to a corporation and its shareholders mirrors the un-

1. The concept embodied in the rule, in the words of one commentator, has been a "recurring theme that began early and has stayed late." Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 367 (1965). See *Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y. 1975); *Smith v. Prattville Mfg. Co.*, 29 Ala. 503 (1857). See also Lewis, *The Business Judgment Rule And Corporate Directors' Liability For Mismanagement*, 22 BAYLOR L. REV. 157 (1970); Note, *The Continuing Viability of the Business Judgment Rule as a Guide For Judicial Restraint*, 35 GEO. WASH. L. REV. 562 (1967); Comment, *The Business Judgment Rule: A Guide To Corporate Directors' Liability*, 7 ST. LOUIS U.L.J. 151 (1962). Although the obligations and potential liabilities of executive officers are quite often identical to those of directors, this Comment addresses only the legal relationship of directors to their corporation.

2. 241 F. Supp. 705 (E.D. Pa. 1965).

3. *Id.* at 712.

4. See notes 16-28 *infra* and accompanying text.

certainty regarding the legal responsibility of corporate directors. Consequently, directors act with few real guidelines to influence their office, and corporate representatives and shareholders face an uncertain result when they seek judicial redress for damages to corporate interests under allegations of negligent mismanagement. Occasional decisions based on federal securities law, however, suggest that directors may be held to a more clearly defined standard of conduct in their function as corporate managers.⁵ This Comment assesses the role that the business judgment rule has played in shielding directors from legal accountability for their actions in office and suggests that the developments under federal securities law may force a resolution of the dilemma that faces shareholders and directors alike. While this Comment includes frequent references to Texas law as a point of reference, the laws of other jurisdictions also are examined. First, this Comment examines the divergence between the legal and working models of the corporate power structure. Secondly, this Comment sets forth the common law and statutory duties of directors. Thirdly, the standard of conduct applicable to director conduct is explored. Fourthly, this Comment evaluates the role the business judgment rule has played in modifying this standard of conduct. Finally, the possible influence of federal securities law on director conduct is examined.

I. CORPORATE MANAGEMENT: THE CHANGING ROLE OF THE BOARD OF DIRECTORS

The Texas Business Corporation Act provides that "[t]he business and affairs of a corporation shall be managed by a board of directors."⁶ The provision is typical of the delegation of corporate managerial function under state codes⁷ and is one aspect of power distribution in both public and private corporations. The corporate power structure is viewed as a pyramid,⁸ with shareholders forming the large base, the board of directors occupying a second stratum, and executive officers forming the apex.

5. See, e.g., *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1311 (2d Cir. 1973) (dissenting opinion); *Securities & Exchange Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

6. TEX. BUS. CORP. ACT ANN. art. 2.31 (Vernon 1980).

7. See ARK. STAT. ANN. § 64-301 (1947); ILL. ANN. STAT. ch. 32, § 157.33 (Smith-Hurd Supp. 1980-1981); MICH. COMP. LAWS ANN. § 450.13 (1967); MINN. STAT. ANN. § 301.28(1) (West 1969); PA. STAT. ANN. tit. 15, § 1401 (Purdon Supp. 1980-1981); TENN. CODE ANN. § 48-801 (1979). See also OHIO REV. CODE ANN. § 1701.59A (Page 1978) ("all of the authority of a corporation shall be exercised by its directors"). Some states provide that the management function shall rest in the board unless otherwise provided in the articles of incorporation, in the bylaws, or by shareholder agreement. See COLO. REV. STAT. § 7-5-101 (Supp. 1979); GA. CODE ANN. § 22-701(a) (1977); KAN. STAT. ANN. § 17-6301 (1974); MASS. ANN. LAWS ch. 156, § 25 (Michie/Law. Co-op 1979); N.C. GEN. STAT. § 55-24(a) (1975); N.J. STAT. ANN. § 14A:6-1 (West Supp. 1981-1982); WASH. REV. CODE ANN. § 23A.08.340 (1969). Other states provide that management of corporate affairs shall be by or under the direction of a board of directors. See note 29 *infra*. When citing to state codes, the Texas Act will be cited exclusively if it typifies other corporation codes.

8. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 CAL. L. REV. 375, 376 (1975).

Shareholders elect the board of directors⁹ and vote on the disposition of major corporate actions.¹⁰ The board has authority by law to appoint¹¹ and remove¹² officers and to direct the affairs of the enterprise.¹³ Lastly, executives, while vested with some discretion concerning the conduct of their offices, in theory execute the policy defined by the board.¹⁴ Under this legal scheme the practical power to control corporate affairs stems primarily from the directorial level. The shareholders give general approval to board action while executives actively fulfill the directives of the board.

The legal model implies that directors have an active and intimate involvement in the affairs of the corporation.¹⁵ In closely held corporations the characterization is fairly accurate, because considerable identity of membership exists among the three strata of the power pyramid.¹⁶ With respect to publicly held enterprises, however, the legal model falls short of reflecting the true power structure. The board of a public corporation advises, disciplines, and responds to crisis situations but does not routinely participate in the decision-making process.¹⁷ Typically, the corporation's executive officers establish working policy and manage daily activities.¹⁸ In theory, the divergence from the legal model may be reconciled if executive officers are viewed as agents of the board of directors.¹⁹ Under this view the work of officers would be the work of the board and ratification of executive decisions by the board theoretically would fulfill the statutory mandate that the board itself manage corporate affairs.²⁰ Such a relationship requires that directors monitor officer performance. The appointment

9. TEX. BUS. CORP. ACT ANN. art. 2.32 (Vernon 1980). Article 2.32 also provides that shareholders shall have the power to remove directors from the board. See ABA-ALI MODEL BUS. CORP. ACT §§ 36, 39 (1977).

10. Eisenberg, *supra* note 8, at 376.

11. TEX. BUS. CORP. ACT ANN. art. 2.42A (Vernon 1980).

12. *Id.* art. 2.43.

13. See notes 6 & 7 *supra* and note 29 *infra*. The statutory directive to manage provides little guidance as to the proper function of a board in corporate life. A number of authors have attempted to identify specific activities which would come under the legal obligations of managerial functions. Harold Koontz has proposed the following functions: trusteeship, or safeguarding of corporate assets; determination of enterprise objectives; selection of executives; securing long-range business stability and growth; approval of major company decisions; checking on results of these decisions; disposing of corporate profits and assets; and approval of mergers and acquisitions. H. KOONTZ, THE BOARD OF DIRECTORS AND EFFECTIVE MANAGEMENT 24-31 (1967). See also M. MACE, DIRECTORS: MYTH AND REALITY (1971).

14. The Texas Act provides that "[a]ll officers and agents of the corporation . . . shall have such authority and perform such duties in the management of the corporation as may be provided in the bylaws, or as may be determined by resolution of the board of directors not inconsistent with the bylaws." TEX. BUS. CORP. ACT ANN. art. 2.42B (Vernon 1980). See ABA-ALI MODEL BUS. CORP. ACT § 50 (1977).

15. ABA-ALI MODEL BUS. CORP. ACT ANN. 255 (2d ed. Supp. 1977).

16. M. MACE, *supra* note 13, at 72-73.

17. *Id.* at 13. Mace's conclusions were based on evidence gathered in field research of power distribution in over 600 large, publicly held corporations. The functions listed are those typically performed by outside directors. *Id.* n.3.

18. *Id.* at 184-90. See generally M. SCHAEFTLER, THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS (1976).

19. RESTATEMENT (SECOND) OF AGENCY § 1 (1957).

20. *Id.* § 82.

of executive officers and other full-time corporate employees²¹ to the board disturbs this scheme, however, because these "inside directors" are called upon to oversee policy and other management decisions that they are determining and executing.²²

The board also includes outside directors, those individuals with no working connections to the corporation. Their presence on the board prevents a merger of the executive and director strata.²³ The outside director should bring to the board an unbiased and objective viewpoint in order to maximize the effectiveness of the directorial oversight function and, therefore, should be in an ideal position to evaluate management decisions made by insiders and executives.²⁴ As a rule, however, outside director involvement in corporate affairs is minimal. Outside directors are drawn from other enterprises and professions and convene only periodically to manage the affairs of the corporation.²⁵ Typically, the outside director's decisions are made after evaluating data provided by inside directors and executive officers.²⁶ Restraints on time and information limit severely the amount of impact that outside directors can have upon corporate affairs. In addition, most outside directors hold their positions as a result of sponsorship by insiders or executive officers;²⁷ thus, their tenure on the board depends upon their compatible relationship with this group.²⁸

A number of state corporation codes accomplish a more realistic distri-

21. Eisenberg, *supra* note 8, at 381. See also M. MACE, *supra* note 13, at 112-13.

22. Corporate officers and directors have defended the appointment of inside directors on several grounds: executives may be most efficiently educated on the managerial process at the board level; outside directors are afforded a unique opportunity to evaluate the performance and capabilities of executive officers when they serve together on the board; and the attractiveness and prestige of a position on the board is an invaluable recruitment tool for attracting talented executives into corporate service. These appointments have also been criticized. Some corporate directors and officers recognize that an officer or employee cannot be expected to evaluate objectively the performance of his peer group, particularly of those officers who serve on the board as well. In addition, the appointment of an executive is perceived as a dilution of executive talent and unnecessary because the corporation already has the benefit of that executive's expertise. M. MACE, *supra* note 13, at 111-27.

23. There is an increasing tendency toward the creation of boards that are composed predominately of outside directors. *Id.* at 111-12. See generally A. COHEN & R. LOEB, DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS (1978).

24. It has been noted that until recently the role of the outside director did not differ significantly from that of the inside director except as to the time committed to the endeavor. Outsiders were appointed to provide special expertise, access to political and economic power bases, cosmetic value, and to add an objective viewpoint in times of crisis. The modern view is that the outside director will devote more time to corporate affairs and deal at arm's length with management. A. COHEN & R. LOEB, *supra* note 23, at 46-48.

25. Eisenberg, *supra* note 8, at 378.

26. *Id.* at 380.

27. J. BACON & J. BROWN, CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD 28-29 (Conference Board Rep. No. 646, 1975). The report indicates that it is the chief executive who most commonly controls the composition of the board by nominating members or by exercising a veto power over those who are nominated by the board. *Id.*

28. M. MACE, *supra* note 13, at 80. See J. BACON & J. BROWN, *supra* note 27, at 10. The report notes that "if a director seems to the chief executive to be deficient, the chief executive can ask for, and get, his resignation. It is the chief executive, moreover, who himself defines deficiency: whether it is poor attendance at meetings; failure to do homework between meetings; or a proclivity to ask tough, potentially embarrassing questions." *Id.*

bution of corporate power by providing that management of a corporation shall be by or *under the direction* of the board of directors.²⁹ The Model Business Corporation Act includes such a provision.³⁰ The drafters of this section recognized that the traditional designation of board function implies a necessity for board members' daily involvement in corporate affairs. The present version was aimed specifically at relieving the board of this responsibility.³¹ In addition, state codes that provide the right of the board to delegate authority in limited circumstances³² address the divergence of the working power structure from the statutory model to a more restricted degree. Under Texas law the board may delegate authority either to executive committees composed of select members of the board,³³ or to executive officers and agents of the corporation.³⁴ The right to delegate had been recognized as appropriate in case law prior to its codification³⁵ and represents both a legislative and a judicial recognition that the statutory mandate to manage cannot be construed literally. The right is limited, however, and the Texas Act specifically refuses to relieve directors of liability for certain acts designated to the board by law.³⁶ In addition, the codes of most states, including Texas, relieve directors of liability for negligent or prohibited acts performed in a good faith reliance upon advice, counsel, and information provided by board committees and specified nonboard individuals.³⁷

The current divergence from the legal model of the corporate power/management structure increases the difficulty of providing directors with accurate guidelines to follow in the conduct of their offices. Faced with a statutory mandate to manage and a *de facto* limitation of the position to an advisory role, directors are caught in a dilemma as to their responsibility to the corporation and its shareholders.³⁸ The outside director

29. CAL. CORP. CODE § 300(a) (West Supp. 1981); FLA. STAT. ANN. § 607.111(1) (West 1977); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1980-1981).

30. ABA-ALI MODEL BUS. CORP. ACT § 35 (1977).

31. ABA-ALI MODEL BUS. CORP. ACT ANN. 255 (2d ed. Supp. 1977).

32. DEL. CODE ANN. tit. 8, § 141(c) (Supp. 1980).

33. TEX. BUS. CORP. ACT ANN. art. 2.36 (Vernon 1980).

34. *Id.* art. 2.42B.

35. *San Antonio Joint Stock Land Bank v. Taylor*, 129 Tex. 335, 105 S.W.2d 650 (1937).

36. TEX. BUS. CORP. ACT ANN. art. 2.36 (Vernon 1980). Article 2.36 specifically prohibits the delegation of authority to board committees of certain board functions, including amending the articles of incorporation, approving a plan for merger or consolidation and recommending to the shareholders the sale, lease, or exchange of all or substantially all of the corporation's assets.

37. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(e) (Supp. 1980); ILL. ANN. STAT. ch. 32, § 157.42-10 (Smith-Hurd 1954); TEX. BUS. CORP. ACT ANN. arts. 2.41C-41D (Vernon 1980).

38. M. SCHAEFTLER, *supra* note 18, at 64-65. Schaeftler notes that considerable confusion exists as to how to define the role and duties of outside directors and that this confusion has forestalled for some time attempts by the Securities and Exchange Commission and others to formulate precise legal guidelines. *Id.* at 64. He continues to suggest that the final guidelines should relate, in part, to "questions of the extent to which outside directors may rely on corporate employees, documents, or committee findings; to the scope and nature of the position; and to standards setting forth the responsibilities of outside directors." *Id.* at 65.

is often lacking in orientation to his duties,³⁹ yet the standard of care applicable to directors, which is promulgated under common law and now codified in a number of state corporation acts, makes no distinction between the functions of inside and outside directors.⁴⁰ Increased concern exists over the potential liability of individual directors for the acts of co-directors, executive officers, and other corporate employees.⁴¹ The codification of indemnity statutes⁴² and the increasing use of liability insurance⁴³ reflect this trend.

II. COMMON LAW AND STATUTORY DUTIES OF DIRECTORS

The personal liability of an individual director stems from the breach of some duty that has been imposed through statute or common law. Article 2.41 of the Texas Act⁴⁴ is typical of statutorily determined liabilities. The Act provides that a director will be liable for one of the following actions: voting for or assenting to the declaration of dividends or other distributions of assets contrary to provisions of the Act or the articles of incorporation;⁴⁵ voting for or assenting to the purchase of the corporation's own shares contrary to provisions of the Act;⁴⁶ voting for or assenting to the distribution of assets to shareholders during liquidation proceedings without the prior payment or discharge of corporate obligations;⁴⁷ voting for or assenting to a loan to an officer or director until the loan is repaid;⁴⁸ assenting to the commencement of business before compliance with the statutory requirement of consideration for shares of at least \$1000;⁴⁹ and, in the event of insolvency, voting for or assenting to any payments made out

39. *Id.* at 64.

40. Professor Eisenberg notes that "[s]tandards of care, by the same token, often seem to be pitched to the outside director rather than the executive, as if the former were really running the business." Eisenberg, *supra* note 8, at 384. This situation is a natural consequence of the statutory mandate that directors shall manage corporate affairs. *See notes 6, 7 supra.*

41. *See* M. SCHAEFTLER, *supra* note 18.

42. CAL. CORP. CODE § 317 (West Supp. 1981); N.Y. BUS. CORP. LAW § 723 (McKinney Supp. 1980-1981). *See also* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 587 (3d ed. 1978).

43. *See* M. SCHAEFTLER, *supra* note 18. *See also* W. KNEPPER, *supra* note 42, at 619.

44. TEX. BUS. CORP. ACT ANN. art. 2.41A (Vernon 1980); *see* CAL. CORP. CODE § 309 (West 1977); DEL. CODE ANN. tit. 8, § 174 (1974); N.Y. BUS. CORP. LAW § 719 (McKinney Supp. 1980-1981). *See also* ABA-ALI MODEL BUS. CORP. ACT § 48 (1977). The Model Act is narrower in scope than the Texas provision and provides for liability for any director who: (1) votes for or assents to the declaration of dividends or distribution of assets to shareholders contrary to the provisions of the Act or to restrictions contained in the articles of incorporation; (2) votes for or assents to the purchase of the corporation's own shares contrary to the provisions of the Act; (3) or votes for or assents to any distribution of assets to shareholders during liquidation proceedings without prior discharge of corporate debts and obligations. Unlike the Texas statute, the Model Act affords protection from liability to any director who has complied with a general standard of care provided in the Act. *See* ABA-ALI MODEL BUS. CORP. ACT §§ 35, 48 (1977).

45. TEX. BUS. CORP. ACT ANN. art. 2.41A(1) (Vernon 1980).

46. *Id.* art. 2.41A(2).

47. *Id.* art. 2.41A(3).

48. *Id.* art. 2.41A(4).

49. *Id.* art. 2.41A(5).

of the reduction surplus of the corporation until the satisfaction of all creditor claims.⁵⁰ The Act imposes joint and several liability regardless of issues of causation or damages,⁵¹ with mandatory contribution and indemnity from other directors, or in some instances, from shareholders.⁵²

In addition to liability for breach of a statutory duty, a director may incur liability for breach of a common law duty arising from his legal relationship to the corporation. Whether operating under the traditional mandate to manage corporate affairs or under the more relaxed dictate to oversee and advise, the director exercises a high degree of discretion to shape the affairs of the corporation and consequently is held to a high standard of care and accountability for his actions.⁵³ A few state codes have designated directors as fiduciaries of corporate interests⁵⁴ and, in one case, of shareholder interests.⁵⁵ Most states, including Texas, do not specifically confer this status on the director by statute, but have fully developed the fiduciary relationship in case law.⁵⁶ Three broad duties stem

50. *Id.* art. 2.41A(6).

51. Liability is conferred on any director who votes for or assents to the prohibited actions unless that director can avail himself of one of the two reliance defenses provided in article 2.41. TEX. BUS. CORP. ACT ANN. arts. 2.41C, 41D (Vernon 1980). See notes 124-26 *infra* and accompanying text. See also *Burton Mill & Cabinet Works, Inc. v. Truemper*, 422 S.W.2d 825, 827 (Tex. Civ. App.—Waco 1967, writ ref'd n.r.e.), in which the court imposed a common law liability in excess of the liability imposed by statute for violation of art. 2.41A(2). A director who is present at a meeting is presumed to have assented to the action unless his dissent is entered in the minutes of the meeting or he files a written dissent before or immediately after adjournment of the meeting. TEX. BUS. CORP. ACT ANN. art. 2.41B (Vernon 1980). See generally Hartmann & Wilson, *Payment For Repurchased Shares Under the Texas Business Corporation Act*, 26 Sw. L.J. 725 (1972); Israels, *Limitations on the Corporate Purchase of Its Own Shares*, 22 Sw. L.J. 755 (1968); Murray, *Legal and Financial Aspects of Dividend Policy*, 23 BAYLOR L. REV. 7, 13 (1971).

52. TEX. BUS. CORP. ACT ANN. arts. 2.41E-41F (Vernon 1980).

53. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949). In *Cohen* the United States Supreme Court noted that "[d]irectors . . . occupy positions of a fiduciary nature, and nothing in the Federal Constitution prohibits a state from imposing on them the strictest measure of responsibility, liability and accountability, either as a condition of assuming office or as a consequence of holding it." *Id.* at 549. See also *Pepper v. Litton*, 308 U.S. 295 (1939).

54. OKLA. STAT. ANN. tit. 18, § 1.34(b) (1951); PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1980-1981).

55. N.C. GEN. STAT. § 55-35 (1975).

56. See, e.g., *United States v. Byrum*, 408 U.S. 125 (1972); *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949); *Pepper v. Litton*, 308 U.S. 295 (1939); *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955); *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Iowa S. Utils. Co. v. United States*, 348 F.2d 492 (Ct. Cl. 1965); *Johnston v. Livingston Nursing Home, Inc.*, 211 So. 2d 151 (Ala. 1968); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (1939); *Dixmoor Golf Club, Inc. v. Evans*, 325 Ill. 612, 156 N.E. 785 (1927); *Parsons Mobile Prods., Inc. v. Remmert*, 531 P.2d 428 (Kan. 1975); *Clark-Lami, Inc. v. Cord*, 440 S.W.2d 737 (Mo. 1969); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). See generally W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 838 (rev. perm. ed. 1975). Courts commonly refer to directors as occupying positions similar to that of trustees or agents. *Dixmoor Golf Club, Inc. v. Evans*, 325 Ill. 612, 156 N.E. 785, 787 (1927) (director is a trustee as to corporation); *Tenison v. Patton*, 95 Tex. 284, 290-93, 67 S.W. 92, 94-95 (1902) (director is trustee); *Dollar v. Lockney Supply Co.*, 164 S.W. 1076, 1079 (Tex. Civ. App.—Amarillo 1914, no writ) (director is trustee as to corporation and shareholders and agent as to creditors or other third parties). Texas and other jurisdictions, however, have recognized that directors are not trustees or agents in a strict sense. *Briggs v.*

from the fiduciary status: obedience, loyalty, and due care.⁵⁷ Unlike statutory liability, a breach of fiduciary duty and the consequent imposition of personal liability requires a demonstration of causation and of damages.⁵⁸

Duty of Obedience. The duty of obedience contemplates the avoidance of ultra vires⁵⁹ acts. The director who exceeds the scope of his authority to the detriment of corporate interests acts at his own peril.⁶⁰ Traditionally, a lack of good faith or negligence must be demonstrated to render a director liable under the ultra vires doctrine.⁶¹ In Texas the performance of an ultra vires act, whether negligent or not, is insufficient to impose personal liability.⁶² While an ultra vires act may be voidable, personal liability will attach only if the challenged action is also illegal.⁶³ In this regard, an illegal act is one in violation of an express statute, or one that is malum in se or against public policy.⁶⁴ The requirement of illegality decidedly limits a director's liability, as negligence or even willful disobedience to the limitations of office will simply result in the enjoining of the offending director's actions in most instances.

Duty of Loyalty. The duty of loyalty requires that a director must act in good faith and that the interests of the corporation must prevail over the personal interests of the director.⁶⁵ A director runs the risk of being labeled "interested," and consequently subject to scrutiny under the duty of loyalty guidelines, if the potential exists for his personal interests, or the interests of an enterprise with which he is associated, to influence his behavior to the detriment of his corporation. Conferral of interested director

Spaulding, 141 U.S. 132, 147 (1891); Paddock v. Siemoneit, 147 Tex. 571, 577, 218 S.W.2d 428, 431 (1949). Recognizing that the duties and obligations of directors may vary from those of trustees or agents, some courts have designated directors as "quasi-trustees" of corporate interests. Schildberg Rock Prods. Co. v. Brooks, 258 Iowa 759, 140 N.W.2d 132, 136 (1966); Braswell v. Morrow, 195 N.C. 127, 141 S.E. 489, 490 (1928).

57. W. KNEPPER, *supra* note 42, at 10-11. See also 20 R. HAMILTON, BUSINESS ORGANIZATIONS §§ 712-18 (Texas Practice 1973).

58. A plaintiff must be able to demonstrate that a director breached his fiduciary duty and that this breach caused harm to corporate interests. In addition, the damages must be ascertainable. See Barnes v. Andrews, 298 F. 614, 616 (S.D.N.Y. 1924).

59. Ultra vires is defined as "[a]cts beyond the scope of the powers of a corporation, as defined by its charter or laws of state of incorporation." BLACK'S LAW DICTIONARY 1365 (5th ed. 1979). See generally W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 38 (5th unabr. ed. 1980).

60. Directors must act within the powers conferred by state codes, the articles of incorporation, and the corporate bylaws. W. KNEPPER, *supra* note 42, at 11.

61. Holmes v. Crane, 191 A.D. 820, 182 N.Y.S. 270, 274 (1920) (negligent disobedience); Leppaluoto v. Eggleston, 57 Wash. 2d 393, 357 P.2d 725, 731 (1960) (willful performance of unauthorized act). See generally W. FLETCHER, *supra* note 56, § 1021.

62. Staacke v. Routledge, 111 Tex. 489, 241 S.W. 994 (1922); Sutton v. Reagan & Gee, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).

63. Staacke v. Routledge, 111 Tex. 489, 241 S.W. 994 (1922).

64. *Id.* Such "illegal" acts should not be considered to be within the sound discretion of a director and, therefore, should not be evaluated under the business judgment rule. See note 137 *infra* and accompanying text. A number of jurisdictions, however, have applied the rule to acts that allegedly were in violation of public policy or federal law. See notes 150-51 *infra*.

65. *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1599 (1978) [hereinafter cited as *Guidebook*].

status is a question of fact,⁶⁶ but as a general rule, the risk of this designation is present when the director makes a personal profit from a transaction by dealing with the corporation or usurping a corporate opportunity,⁶⁷ purchases or sells assets of the corporation,⁶⁸ uses corporate assets for his own benefit,⁶⁹ transacts business in his official capacity with a second enterprise with which he is also associated as a director or by some significant financial basis,⁷⁰ or transacts business in his official capacity with a member of his family.⁷¹ In addition, the compensation that a director receives for his services to the corporation may raise questions of reasonableness if it is so high as to suggest a wasting of corporate assets.⁷²

Under early common law, any transactions involving an interested director were voidable at the insistence of corporate representatives or shareholders.⁷³ The modern view, however, is that while such transactions are subject to strict judicial scrutiny, they are voidable only if the challenged action is found to be unfair to the corporation.⁷⁴ In any instance, findings

66. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). See generally Comment, *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

67. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). See also *Pepper v. Litton*, 308 U.S. 295 (1939); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (1939); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 121 N.E. 378 (1918). In many states the corporation code contains provisions that govern the transactions between a director and his corporation. See DEL. CODE ANN. tit. 8, § 144 (1974); MICH. COMP. LAWS § 450.1545 (West 1973); OHIO REV. CODE ANN. § 1701.60 (Page 1978). See also ABA-ALI MODEL BUS. CORP. ACT § 41 (1977). The Texas Act does not include a conflict of interest provision.

68. *Niagara Fire Ins. Co. v. Numismatic Co.*, 380 S.W.2d 830 (Tex. Civ. App.—Fort Worth 1964, writ ref'd n.r.e.); *Brooks v. Zorn*, 24 S.W.2d 742 (Tex. Civ. App.—Beaumont 1929, writ dism'd); *Allen v. Hutcheson*, 57 Tex. Civ. App. 71, 121 S.W. 1141 (1909, writ ref'd).

69. *Scott v. Farmers' & Merchants' Nat'l Bank*, 97 Tex. 31, 75 S.W. 7 (1903); *Duncan v. Ponton*, 102 S.W.2d 517 (Tex. Civ. App.—Fort Worth 1937, no writ).

70. *Reynolds-Southwestern Corp. v. Dresser Indus., Inc.*, 438 S.W.2d 135 (Tex. Civ. App.—Houston [14th Dist.] 1969, writ ref'd n.r.e.); see *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 121 N.E. 378 (1918).

71. *Davis v. Nueces Valley Irrigation Co.*, 103 Tex. 243, 126 S.W. 4 (1910).

72. *Todd v. Southland Broadcasting Co.*, 231 F.2d 225 (5th Cir.), cert. denied, 352 U.S. 845 (1956); *Nelms v. A & A Liquor Stores, Inc.*, 445 S.W.2d 256 (Tex. Civ. App.—Eastland 1969, writ ref'd n.r.e.); *A.J. Anderson Co. v. Kinsolving*, 262 S.W. 150 (Tex. Civ. App.—San Antonio 1924, writ dism'd).

73. *Wardell v. Union Pac. R.R.*, 103 U.S. 651 (1880); see *Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966). Several early Texas cases adopted this view. *Texas Auto Co. v. Arbetter*, 1 S.W.2d 334 (Tex. Civ. App.—San Antonio 1927, writ dism'd); *Canadian Country Club v. Johnson*, 176 S.W. 835 (Tex. Civ. App.—Amarillo 1915, writ ref'd).

74. In *Pepper v. Litton*, 308 U.S. 295, 306 (1939), the United States Supreme Court noted that directors' "dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director . . . not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein." See also *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Henger v. Sale*, 365 S.W.2d 335 (Tex. 1963); *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961); *Western Inn Corp. v. Heyl*, 452 S.W.2d 752 (Tex. Civ. App.—Fort Worth 1970, writ ref'd n.r.e.); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App.—Beaumont 1962, writ ref'd n.r.e.). State codes that govern director conflict of

of fraud, over-reaching or waste of corporate assets will confer liability upon the offending director and will result in the voiding of the transaction.⁷⁵ Otherwise, a director must carry the burden of proving that the challenged action is fair to the corporation.⁷⁶ If a particular transaction fails under the fairness test, Texas courts still may uphold it if it is ratified by a majority of disinterested directors or by a majority of shareholders.⁷⁷ In Texas the interested director who also is a shareholder may vote to ratify his challenged act.⁷⁸

Texas breach of loyalty cases indicate that a director may profit personally from an interested transaction, but only if the profit is incidental to his promotion of corporate interests. In *International Bankers Life Insurance Co. v. Holloway*⁷⁹ the Texas Supreme Court noted that a director's acceptance of a commission for the sale of corporate stock was "incompatible with the duty of good faith owed to the plaintiffs by the directors."⁸⁰ Under the *International* holding, a breach of fiduciary duty may occur in the absence of intent to usurp a corporate opportunity because the director in this instance received commissions that the board previously had authorized.⁸¹ The good faith requirement, which the holding in *International* demands, appears to require that a director act with an intent to confer benefit on the corporation and not simply with an intent not to injure the corporation.⁸²

Duty of Care. The duty of care requires a director to be diligent and prudent in his management of corporate affairs. The terminology commonly used when discussing the duty resembles the ordinary negligence standard and suggests a demand for reasonableness in the conduct of an individual as director.⁸³ Judicial references to the duty appear consistently in Texas and other jurisdictions, and state codes, as well as the Model Act,⁸⁴ have

interest provide guidelines for evaluating whether a transaction should be upheld. See note 67 *supra*. See also ABA-ALI MODEL BUS. CORP. ACT § 41 (1977).

75. *Allen v. Wilkerson*, 396 S.W.2d 493 (Tex. Civ. App.—Austin 1965, writ ref'd n.r.e.); *Mercury Life & Health Co. v. Hughes*, 271 S.W.2d 842 (Tex. Civ. App.—San Antonio 1954, writ ref'd); *Duncan v. Ponton*, 102 S.W.2d 517 (Tex. Civ. App.—Fort Worth 1937, no writ); *Allen v. Hutcheson*, 57 Tex. Civ. App. 71, 121 S.W. 1141 (1909, writ ref'd).

76. *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961).

77. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Tenison v. Patton*, 95 Tex. 284, 67 S.W. 92 (1902); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App.—Beaumont 1962, writ ref'd n.r.e.). In *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.), the court noted that shareholders may ratify a transaction founded in fraud or overreaching by unanimous vote in the absence of injury to creditors.

78. *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App.—Beaumont 1962, writ ref'd n.r.e.).

79. 368 S.W.2d 567 (Tex. 1963).

80. *Id.* at 578.

81. *Id.* at 575.

82. *Id.* at 578.

83. Courts commonly evaluate allegations of negligent mismanagement by asking the question as to whether the challenged action had a sound business rationale. This is a short-hand manner of applying the business judgment rule.

84. The scope of the duty of due care, as designated in case law and by statute, is discussed in notes 88-115 *infra* and accompanying text.

incorporated negligence standards. Parameters of the duty of care, however, are difficult to define, and as a result, the standard of care applicable to director conduct is susceptible of varying interpretations.

In summary, the fiduciary status of a director demands that he be obedient, loyal, and diligent while handling the interests of his corporation. Theoretically, a breach of any one of these duties, causing damage to the corporation, should confer personal liability on the offending director and on those other directors who aided or assented to his action. Case law, however, indicates a significant divergence from the legal standards that these duties dictate and presents a dichotomy between standards that arise from the fiduciary status of directors and those that the courts use.⁸⁵ The divergence may reflect the unsatisfactory position of the director as manager under law but advisor and overseer in fact,⁸⁶ and may represent a judicial reluctance to enforce a legal scheme that inaccurately describes a director's function in the modern, publicly held corporation. This Comment proposes that the courts use the business judgment rule as a tool to avoid applying the standards of conduct that naturally flow from the fiduciary relationship.

III. STANDARDS OF CONDUCT APPLICABLE TO CORPORATE DIRECTORS

The standards of conduct that are applicable to directors result from a synthesizing of the legal responsibilities arising from the duties of loyalty and due care. The duty of loyalty demands that a director act in the best interest of the corporation and be motivated by an intent to benefit and further corporate interests.⁸⁷ The requirement that stems from the duty of due care is less susceptible of precise definition. Courts unanimously require a director to act in good faith, indicating that he must be honest and believe that his decisions will benefit the corporation.⁸⁸ As such, the good faith requirement is a mandate to avoid actions that are reckless, willful or grossly negligent.⁸⁹ The degree of care required under this duty is more difficult to define. The law of the nineteenth century established that directors are bound to exercise ordinary care, skill, and diligence in the conduct of corporate affairs.⁹⁰ The often quoted holding in *Hun v. Carey*,⁹¹ represents the general standard: "One who voluntarily takes the position of director and invites confidence in that relation, undertakes . . . that he possesses at least ordinary knowledge and skill, and that he will bring

85. See note 149 *infra* and accompanying text.

86. See notes 17-28 *supra* and accompanying text.

87. See notes 65-82 *supra* and accompanying text.

88. See, e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). Good faith is an element of the statutory standards of care provided in a variety of state corporation acts. See notes 111-12 *infra* and accompanying text. See also ABA-ALI MODEL BUS. CORP. ACT § 35 (1977).

89. See *Guidebook*, *supra* note 65, at 1599-1601.

90. For a discussion of early cases dealing with the director standard of care, see 55 L.R.A. 751 (1902).

91. 82 N.Y. 65 (1880).

these to bear in the discharge of his duties."⁹²

In *Hun* the board of directors of a bank incurred debts for development of capital assets that were far in excess of those that its financial base warranted. After the bank failed, the trustee in bankruptcy charged the directors with negligence in the investment of funds. The bank directors defended their actions by claiming that the overreaching resulted from "errors of judgment."⁹³ In affirming a finding of liability for negligent mismanagement the New York Court of Appeals discussed at length the rationale for applying a standard of ordinary skill and care to director conduct.⁹⁴ The court recognized that too high a standard of care would discourage even the most competent and diligent of individuals from accepting the risks normally associated with any business enterprise.⁹⁵ Conversely, too low a standard would fail to protect investors from mismanagement of their assets and consequently would discourage entry into investment markets.⁹⁶ For these reasons, the court found that something more demanding than a gross negligence standard must serve as a basis for determining director liability.⁹⁷ While other early cases appeared to require willful or reckless conduct or fraud to render a director liable,⁹⁸ the *Hun* court interpreted many of these cases as in fact utilizing a criterion of ordinary negligence.⁹⁹

Difficulties arise, however, when an attempt is made to define with greater precision a standard of care that is applicable to directors, because any standard must be flexible enough to accommodate a variety of business transactions.¹⁰⁰ Most states require ordinary care in the conduct of

92. *Id.* at 74.

93. *Id.* at 67. A finding that the challenged action resulted from an error or mistake in business judgment triggers the application of the business judgment rule and, consequently, the exoneration of the defendant from liability for negligent mismanagement. Judicial distinctions between mistakes in business judgment and breaches in fiduciary duty are discussed at notes 141-45 *infra* and accompanying text.

94. 82 N.Y. at 70-74.

95. *Id.* at 70-71. The *Hun* court's concern that too high a standard of care would discourage able individuals from accepting board positions has been a significant factor in the development of the business judgment rule. See *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944), in which a New York court noted that "to encourage freedom of action on the part of directors, or to discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the business judgment rule."

96. *Hun v. Carey*, 82 N.Y. 65, 71 (1880).

97. *Id.* at 73-74.

98. See cases cited in 55 L.R.A. 751, 754-55 (1902). The most notable among these is *Spering's Appeal*, 71 Pa. 11 (1872), in which the Pennsylvania Supreme Court held: [W]hile directors are personally responsible to the stockholders for any losses resulting from fraud, embezzlement or wilful misconduct or breach of trust for their own benefit and not for the benefit of the stockholders, for gross inattention and negligence by which such fraud or misconduct has been perpetrated by agents, officers or co-directors, yet they are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confided to the managing body.

Id. at 24.

99. *Hun v. Carey*, 82 N.Y. 65, 72 (1880).

100. *Id.* at 71; see ABA-ALI MODEL BUS. CORP. ACT ANN. 257 (2d ed. Supp. 1977).

directors, but the judicial evaluation of the requisite attention to duty may vary from state to state. Two variant approaches exist. One line of cases has held that the care a director exercises should be that which a prudent man would give to his personal affairs.¹⁰¹ This standard, however, has been criticized as requiring, under a literal construction, an unrealistic degree of attention to what is a part-time endeavor.¹⁰² The trend is toward adopting a more flexible standard under which the requisite degree of care is that which a prudent man in a like position under similar circumstances would give.¹⁰³ The flexibility of this standard accommodates the various levels of director involvement in management. By depending on custom and usage, the standard protects the outside director from the expectation that he will give his undivided attention to corporate interests.¹⁰⁴

The question of what degree of skill and knowledge the standard of care requires also has caused confusion. The *Hun* decision implied that a skill equal to the task was essential.¹⁰⁵ The court reasoned that those who voluntarily choose to be directors and who are remunerated for their efforts must be competent to perform.¹⁰⁶ This view, which a number of jurisdictions have adopted,¹⁰⁷ suggests that the standard of care properly refers to a prudent businessman rather than merely a prudent man. Most courts and state codes, however, do not require any special skills.¹⁰⁸ In cases of extreme incompetence, liability may attach on the assumption that accepting the responsibilities of a seat on the board was negligent.¹⁰⁹ For the most part, though, the law readily forgives lack of skill in performance of the office.¹¹⁰ Contrary to scattered case law and statutes that require skill and knowledge, the incompetent but well-meaning director ordinarily will be immune from liability for losses that are incurred through his improvidence. Application of the standard of care raises a question as to whether the standard incorporates prudence except under the most extreme circumstances.

In 1974 the Model Act was amended to provide the following standard:

101. See, e.g., *Besselieu v. Brown*, 177 N.C. 65, 97 S.E. 743 (1919); *Seale v. Baker*, 70 Tex. 283, 7 S.W. 742 (1888).

102. *Selheimer v. Manganese Corp.*, 423 Pa. 563, 224 A.2d 634 (1966).

103. *Briggs v. Spaulding*, 141 U.S. 132 (1891); *Hun v. Carey*, 82 N.Y. 65 (1880).

104. *Briggs v. Spaulding*, 141 U.S. 132 (1891); see ALI-ABA MODEL BUS. CORP. ACT ANN. 257 (2d ed. Supp. 1977), in which drafters of the Model Act's standard of care noted that the "phrase 'under similar circumstances' is intended . . . to recognize that the nature and extent of oversight will vary, depending upon such factors as the size, complexity and location of activities carried on by the particular corporation"

105. *Hun v. Carey*, 82 N.Y. 65, 74 (1880).

106. *Id.*

107. See, e.g., PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1980-1981). See also *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940).

108. Drafters of the Model Act noted that skill never has been considered a qualification for a position on the board. As a result, they specifically avoided incorporating this requirement into the Act's standard of care because of the paucity of judicial authority as to what skill is expected of a board member. ABA-ALI MODEL BUS. CORP. ACT ANN. 256 (2d ed. Supp. 1977).

109. *Lewis, The Business Judgment Rule and Corporate Directors' Liability For Mismanagement*, 22 BAYLOR L. REV. 157, 170 (1970).

110. *Id.*

"A director shall perform his duties as director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances."¹¹¹ The standard, which reflects the common law, was added in response to a number of states' codification of similar standards,¹¹² in the hope of promoting a uniform guide to director liability.¹¹³ The provision includes a right to rely on information, opinions, reports, and statements from board committees, officers and other corporate employees, attorneys, accountants, and other experts whom the director reasonably believes to be reliable.¹¹⁴ This general standard of care governs the reliance defense. By providing such a defense, avoiding an explicit reference to skill and diligence as requisite to due care, and incorporating the similar circumstances alternative, the drafters of the provision hoped to provide a flexible guide to director conduct that would accommodate both the inside and outside director and would stress practical wisdom and common sense as attributes of the office.¹¹⁵

The leading Texas case dealing with the director's standard of care is *McCullum v. Dollar*,¹¹⁶ in which a creditor sued corporate directors for conversion of goods, subsequent misappropriation of funds, and negligence in the management of the corporation for failure to prevent the misappropriation of funds. The last cause of action directly raised the question of due care. The commission of appeals held that a director must discharge his duties with such care as "an ordinarily prudent man would use under similar circumstances."¹¹⁷ The court presented this standard without reference to an earlier decision, *Seale v. Baker*,¹¹⁸ in which the Texas Supreme Court cited with approval a "personal affairs" variant.¹¹⁹ The *McCullum* court noted that the question of director negligence is largely relative and must be decided on a case-by-case basis as a question of fact.¹²⁰ Thus, the apparent differences in the standards that the courts advanced in *McCullum* and *Seale* are likely to be largely semantic.¹²¹

111. ABA-ALI MODEL BUS. CORP. ACT § 35 (1977).

112. See, e.g., CAL. CORP. CODE ANN. § 309(a) (West 1977); PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1980-1981).

113. ABA-ALI MODEL BUS. CORP. ACT ANN. 254 (2d ed. Supp. 1977).

114. ABA-ALI MODEL BUS. CORP. ACT § 35 (1977). By broadening the range of situations in which directors will have the right to rely and the range of materials upon which they can rely, this provision is responsive to the increasing complexity of corporate management responsibilities. ABA-ALI MODEL BUS. CORP. ACT ANN. 254 (2d ed. Supp. 1977).

115. *Id.* at 253-57.

116. 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved).

117. *Id.* at 261.

118. 70 Tex. 283, 7 S.W. 742 (1888).

119. *Id.* at 291, 7 S.W. at 745.

120. 213 S.W. at 261.

121. Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 371 (1965). *But see* Handler & Christy, *Texas Corporate Directors' Standard of Care and Right to Rely: A Proposed Modification*, 8 TEX. TECH L. REV. 291, 307 (1976), in which the authors note that "a . . . jury's misimpression that the 'personal affairs' variant requires a director to devote all or substantially all his time to the corporation may tend to facilitate a finding that an outside director has failed to satisfy the standard." The *Seale* decision, however, involved accusations against bank directors, and some courts have held that bankers should be held to a

Few Texas cases since *McCullum* have attempted to define a director standard of care. While it is common for Texas courts to admit that directors will be held liable for negligent mismanagement of their corporations, most courts simply refer to directors as fiduciaries,¹²² implying an expectation of a high degree of care. The courts note that the director, as fiduciary, is obliged to exercise an unbiased or uncorrupt business judgment in pursuit of corporate interests.¹²³ The modern view definitely stresses the duty of loyalty, and avoids specific discussion of the parameters of due care.

Texas has incorporated a standard of care into statutory provisions that impose liability upon directors in certain circumstances.¹²⁴ The standard allows a director to escape liability for violation of statutory or common law duties if he relied on financial information or legal advice of officers, accountants, or attorneys.¹²⁵ The standard reflects the due care and good faith requirements that have developed in case law.¹²⁶ Since the adoption of this approach in 1955, however, no litigation has defined the scope of the ordinary care defense.

The negligent director should be held liable to his corporation only for damages that his mismanagement causes. Only corporate representatives or shareholders, through the device of a derivative suit,¹²⁷ may pursue a legal remedy for these damages. Although early Texas cases indicated that third party claimants may sustain an action against directors for negligent management of corporate affairs,¹²⁸ the better view is that such plaintiffs lack the requisite standing to sue for damages accruing to corporate inter-

standard of care higher than that of directors of other corporations. *Cosmopolitan Trust Co. v. Mitchell*, 242 Mass. 95, 136 N.E. 403 (1922); *Greenfield Sav. Bank v. Abercrombie*, 211 Mass. 252, 97 N.E. 897 (1912); *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

122. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963); *Tenison v. Patton*, 95 Tex. 284, 290-91, 67 S.W. 92, 93-94 (1902); *Dowdle v. Texas Am. Oil Corp.*, 503 S.W.2d 647, 651 (Tex. Civ. App.—El Paso 1973, no writ); *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ); *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).

123. *In re Westec Corp.*, 434 F.2d 195, 202 (5th Cir. 1970); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).

124. TEX. BUS. CORP. ACT ANN. art. 2.41C (Vernon 1980).

125. *Id.* art. 2.41D. Article 2.41C applies specifically to violations of art. 2.41A(1)-(3). See notes 45-47 *supra* and accompanying text. Article 2.41D has an application unrestricted to any specific statutory liability and provides:

A director shall not be liable for any claims or damages that may result from his acts in the discharge of any duty imposed or power conferred upon him by the corporation if, in the exercise of ordinary care, he acted in good faith and in reliance upon the written opinion of an attorney for the corporation.

126. *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved). See *Handler & Christy, supra* note 121. The authors advocate the adoption of a modified version of the revised Model Act § 35 into the Texas Act to establish a "substantially uniform and flexible 'similar circumstances' standard of care for Texas corporation directors and also to avoid any confusion engendered by the existing case law." *Id.* at 321. In addition, the authors suggest that the Texas Act should include a broader right-to-rely provision so that the Act may be more responsive to modern corporate needs. *Id.*

127. See notes 163-67 *infra* and accompanying text.

128. *Seale v. Baker*, 70 Tex. 283, 7 S.W. 742 (1888); *McCullum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved).

ests.¹²⁹ This view has been justified on two grounds. First, the right to recover is a corporate asset that properly is vindicated only by corporate representatives because the legal harm is to the corporation.¹³⁰ Secondly, the duty of loyalty is paramount to any care that a director might owe to third party claimants.¹³¹ Under the latter view, a director's action that causes harm to a third party will not result in liability if the best interests of the corporation motivated the action.¹³²

Texas law has established two exceptions to the rule that grants immunity from third party suits. A director may be held liable for tortious conduct if he participated in the wrong or had actual or constructive knowledge of the wrong.¹³³ In such instances, a corporation itself is liable in tort and the participating director is regarded as a joint tortfeasor. The second exception involves what has been designated the trust fund doctrine, whereby directors will be held liable to creditors who failed to receive an equitable share of corporate assets after insolvency of a corporation.¹³⁴ Under this theory, directors and officers of the insolvent corporation are viewed as trustees of corporate assets for the benefit of creditors and, therefore, become fiduciaries of creditor interests. This status will impose a liability for breach of fiduciary duty similar to that liability accruing from the director's relationship to a corporation or to its shareholders.

IV. THE BUSINESS JUDGMENT RULE: A SHIELD TO ACCUSATIONS OF LACK OF DUE CARE

In *Hun v. Carey*¹³⁵ the New York Court of Appeals noted that directors who "act in good faith within the limits of power conferred, using proper prudence and diligence . . . are not responsible for mere mistakes or errors of judgment."¹³⁶ The court was articulating what would come to be known as the business judgment rule. The rule may apply when the dis-

129. 7 W. DORSANEY & P. WINSHIP, TEXAS LITIGATION GUIDE § 160.09 (1980).

130. *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).

131. *Maxey v. Citizens Nat'l Bank*, 507 S.W.2d 722 (Tex. 1974).

132. *Id.* at 726. *See also* *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.). The *Sutton* court also noted that recovery by an individual creditor would not bar recovery by the corporation for negligence of a director and consequently, to permit creditors to recover would expose directors to a double liability. *Id.* at 835.

133. *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved) (co-mingling of funds); *Permian Petroleum Co. v. Barrow*, 484 S.W.2d 631 (Tex. Civ. App.—El Paso 1972, no writ) (misappropriation of funds owing to a third party); *Penroc Oil Corp. v. Donahue*, 476 S.W.2d 849 (Tex. Civ. App.—El Paso 1972, writ ref'd n.r.e.) (misrepresentation); *Bower v. Yellow Cab Co.*, 13 S.W.2d 708 (Tex. Civ. App.—El Paso 1929, writ ref'd) (conversion of corporate stock).

134. *Lyons-Thomas Hardware Co. v. Perry Stove Mfg. Co.*, 86 Tex. 143, 24 S.W. 16 (1893); *Tigrett v. Pointer*, 580 S.W.2d 375 (Tex. Civ. App.—Dallas 1978, writ ref'd, n.r.e.); *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ). *See also* *Pepper v. Litton*, 308 U.S. 295 (1939).

135. 82 N.Y. 65 (1880).

136. *Id.* at 70.

cretionary, as opposed to the ministerial, actions of directors are challenged.¹³⁷ It represents a judicial reluctance to exercise hindsight in evaluating the wisdom of business ventures that have gone sour.¹³⁸ In addition, courts have perceived the rule as a device to encourage initiative in enterprise decisions by providing protection for imaginative and innovative directors from allegations of mismanagement.¹³⁹

The *Hun* court rule articulates the simple notion that if a director pays heed to his fiduciary duties of loyalty, obedience, and due care he will not be held liable by virtue of his position on the board. As such, application of the rule is tantamount to a qualitative assessment of a director's attention to his fiduciary duty.¹⁴⁰ Examination of case law, however, leads to the conclusion that the true function of the business judgment rule has been to shield directors from application of an ordinary care standard of conduct. Consequently, the use of the business judgment rule has weakened the negligence standard that is relevant to mismanagement issues. As a result, the standard of care that case law and statute describe may have little practical relevance to American corporate law.

When addressing questions of director misconduct the courts have distinguished acts of nonfeasance and malfeasance from discretionary actions which they have designated as business judgments.¹⁴¹ Courts traditionally have expressed a willingness to hold a director liable for the consequences of his failure to act.¹⁴² Nonfeasance includes those situations in which directors essentially have abdicated their directorships by failing to attend to significant responsibilities of their positions.¹⁴³ The business judgment rule is not applicable to these situations because courts do not perceive inaction as within the realm of permissible discretion.¹⁴⁴ In contrast, when the action (as distinguished from the inaction) of a board member is challenged, courts have been willing to attach liability only upon proof of mal-

137. The fulfillment of ministerial duties allows no opportunity for the exercise of discretion. *W. FLETCHER, supra* note 56, § 1039. These acts are dictated by statute, by articles of incorporation, and by corporate bylaws.

138. *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940).

139. *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

140. *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

141. *Kamin v. American Express Co.*, 86 Misc. 2d 809, 383 N.Y.S.2d 807, 811 (Sup. Ct.), *aff'd*, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1976).

142. *Briggs v. Spaulding*, 141 U.S. 132 (1891); *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924); *Fisher v. Parr*, 92 Md. 245, 48 A. 621 (1901); *Casey v. Woodruff*, 49 N.Y.S.2d 625 (Sup. Ct. 1944).

143. *Atherton v. Anderson*, 99 F.2d 883 (6th Cir. 1938); *Gamble v. Brown*, 29 F.2d 366 (4th Cir.), *cert. denied*, 279 U.S. 839 (1928); *Index Fund, Inc. v. Hagopian*, 417 F. Supp. 738 (S.D.N.Y. 1976); *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.C. Cir. 1974); *Rankin v. Cooper*, 149 F. 1010 (W.D. Ark. 1907); *Barr v. Wackman*, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975); *Neese v. Brown*, 405 S.W.2d 577 (Tenn. 1964).

144. *Casey v. Woodruff*, 49 N.Y.S.2d 625 (Sup. Ct. 1944). In *Casey* the court noted that directors must have a wide latitude in the management of corporate affairs but observed that "[a] director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment." *Id.* at 643. See also *Francis v. United Jersey Bank*, 162 N.J. Super. 355, 392 A.2d 1233 (Super. Ct. Law Div. 1978) (figurehead directors will not be tolerated).

feasance, that is, if the director's actions have been founded in fraud, recklessness, or a breach of the duty of loyalty.¹⁴⁵ Courts have resolved allegations of misfeasance, without more, by designating the challenged activity as a mistake of business judgment. Most often this results in the exoneration of the director-defendant under the business judgment rule. In such cases, the director merely must have acted in good faith and without a corrupt motive.¹⁴⁶

The business judgment rule has been viewed as a defense to allegations of negligent mismanagement,¹⁴⁷ or as a rule of judicial restraint¹⁴⁸ by which courts avoid involvement in the assessment of complex business affairs. Neither view, however, accurately addresses the true impact of the rule. In reality the application of the business judgment rule has excised the requirement that directors exercise ordinary care in the conduct of their offices. Despite an avowed adherence to a standard of conduct that embraces an obligation to act with due care, courts in fact have enforced a standard that requires only good faith and attention to the duty of loyalty.¹⁴⁹ Courts have extended the judicial shielding from liability for negligence to acts that are in violation of an express statute¹⁵⁰ or contrary to public policy.¹⁵¹

145. See, e.g., *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259 (3d Cir. 1978), cert. denied, 439 U.S. 1129 (1979) (bad faith, corrupt motive); *Polin v. Conduccion Corp.*, 552 F.2d 797 (8th Cir.), cert. denied, 434 U.S. 857 (1977) (bad faith, gross abuse of discretion); *Newman v. Forward Lands, Inc.*, 430 F. Supp. 1320 (E.D. Pa. 1977) (fraud; but negligence, recklessness insufficient to confer liability); *Mortgage Brokerage Co. v. Mills*, 100 Colo. 267, 67 P.2d 68 (1937) (bad faith); *Penn Mart Realty Co. v. Becker*, 298 A.2d 349 (Del. Ch. 1972) (fraud, self-dealing, gross negligence, waste of corporate assets); *Kaplan v. Centex Corp.*, 284 A.2d 119 (Del. Ch. 1971) (gross abuse of discretion, bad faith); *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) (fraud, bad faith); *Papalexios v. Tower West Condominium*, 401 A.2d 280 (N.J. 1979) (fraud, self-dealing, unconscionable conduct).

146. See, e.g., *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978) (honesty and fair dealing required); *Nursing Home Bldg. Corp. v. DeHart*, 13 Wash. App. 489, 535 P.2d 137 (1975) (good faith).

147. Comment, *The Business Judgment Rule: A Guide to Corporate Directors' Liability*, 7 ST. LOUIS U.L.J. 151 (1962).

148. Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562 (1967).

149. Courts often recognize due care standards and then proceed to apply less demanding standards to the facts of the case. This inconsistency is illustrated in *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963). Plaintiff, in a derivative suit, charged directors with mismanagement for failing to discover the antitrust violations of certain managerial employees. The court noted in a dictum that "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances." *Id.* at 130. In commenting on the potential liability of directors who fail to supervise management activities, the court noted that if a director "has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." *Id.* The standard of care described in the former passage and the one in fact applied to the claim of mismanagement cannot be reconciled. See Cary & Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61 (Special Issue, Feb. 1972), in which Professor Cary complained that the "standard of duty of care . . . is indeed at a low level." *Id.*

150. *Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y. 1975).

151. *Kelly & Wyndham, Inc. v. Bell*, 266 A.2d 878 (Del. 1970).

This view is apparent in the holding of the Second Circuit Court of Appeals in *Lanza v. Drexel & Co.*¹⁵² *Lanza* involved allegations of violations of federal securities law¹⁵³ and did not raise the issue of application of the business judgment rule.¹⁵⁴ The holding is significant under the common law, however, because it addresses the extent of a director's obligations to supervise corporate affairs.¹⁵⁵ In *Lanza* the plaintiffs alleged that misrepresentations in stock registration statements induced them to exchange their shares for shares in another corporation that subsequently became insolvent. In exonerating one of the outside directors, the court held that a director owes no duty to scrutinize all materials conveyed to prospective purchasers.¹⁵⁶ In order to hold a director liable, the court stated, a plaintiff must show that the director either had knowledge of the misrepresentation¹⁵⁷ or that his failure to discover the misrepresentation amounted to a "willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge."¹⁵⁸ The *Lanza* decision established that: a director is not an insurer of the honesty of executive officers;¹⁵⁹ a director is not under a duty to investigate a transaction in which he did not personally participate;¹⁶⁰ and a person in control will not be held liable when he did not exercise the control to bring about the fraudulent conduct of other corporate directors and employees.¹⁶¹ The holding is based on an interpretation of federal securities law, but the narrow view of a director's role that the opinion expresses parallels that which the common law adopted.¹⁶²

152. 479 F.2d 1277 (2d Cir. 1973).

153. Plaintiff alleged violations of 15 U.S.C. § 78j(b) (1976), which makes it unlawful to employ manipulative or deceptive devices in connection with the sale or purchase of securities.

154. The violation of a law should not be considered to be within the realm of permissible discretion. Courts traditionally have refused to apply the business judgment rule when federal laws have been violated. *See, e.g.*, *Downing v. Howard*, 162 F.2d 654 (3d Cir.), *cert. denied*, 332 U.S. 818 (1947) (failure to register with Securities and Exchange Commission); *Halpern v. Pennsylvania R.R.*, 189 F. Supp. 494 (E.D.N.Y. 1960) (violation of National Labor Relations Act); *Knopfler v. Bohlen*, 15 A.D.2d 922, 225 N.Y.S.2d 609 (1962) (antitrust law violations). *But see* *Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y. 1975), in which the court applied the business judgment rule in evaluating plaintiff's right to proceed in a derivative suit, despite allegations that directors had violated federal investment laws. *See* notes 170-84 *infra* and accompanying text.

155. *W. KNEPPER*, *supra* note 42, at 26.

156. 479 F.2d at 1289.

157. *Id.* at 1304. The court rejected plaintiff's claim that prior federal decisions had recognized negligence as a standard for the imposition of liability for violation of 15 U.S.C. § 78j(b) (1976). *Id.* at 1304-5.

158. *Id.* at 1305.

159. *Id.* at 1281.

160. *Id.*

161. *Id.* at 1298.

162. *See, e.g.*, *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963). *But see* the minority opinion in *Lanza* in which the dissenting judges stated that a director breaches a duty owed to his corporation when he fails to inform himself of the activities of the corporation and that negligence in failing to keep informed should be sufficient to hold a director liable for failure to supervise management decisions. 479 F.2d at 1317-20. The Commissioner of the Securities and Exchange Commission cited with approval the minority guidelines in *Lanza*. Sommer, *Directors and the Federal Securities Law*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,669.

The business judgment rule has had a significant impact not only on the standard of care applicable to director conduct but also on the availability of courts to shareholders seeking judicial redress for legal harms to corporate interests. A shareholder, as representative of his class, may sue offending directors and corporate employees by means of a derivative suit.¹⁶³ Initially, the shareholder must make demand on the board of directors, or those members of the board who are disinterested and impartial, to institute action on behalf of the corporation.¹⁶⁴ The demand requirement is based on the concept that directors, as managers of corporate interests, are the proper party plaintiffs to vindicate harms to corporate rights.¹⁶⁵ A shareholder may avoid the demand requirement if he can demonstrate that demand would be futile, that is, if the existing board would be antagonistic to his proposed cause¹⁶⁶ or if the board is not impartial and would therefore be incapable of rendering an unbiased decision on the matter.¹⁶⁷ When demand is made and refused, the propriety of a board's refusal to sue is evaluated under the business judgment rule.¹⁶⁸ If it is determined that refusal to institute action is based on a sound business rationale, a shareholder is precluded from pursuing a legal remedy for his grievance.¹⁶⁹

Recent federal decisions have extended the impact of the business judgment rule on the course of a derivative suit. In *Lasker v. Burks*¹⁷⁰ shareholders of an investment company brought a derivative suit against some of the company's directors, alleging that the directors had violated provisions of the Investment Company Act¹⁷¹ and the Investment Advisors Act.¹⁷² A disinterested minority of outside directors sought to terminate the action, claiming that the prosecution would be contrary to the best interests of the corporation and its shareholders.¹⁷³ In opposing the directors' motion to dismiss, the plaintiff-shareholder argued that because the challenged action allegedly violated a federal law, the decision of the board not to prosecute could not be a matter of business judgment; that refusal to prosecute would be tantamount to an unlawful ratification of the challenged action; and that because a majority of the board was disqualified, the disinterested minority did not possess the requisite authority to

163. FED. R. CIV. P. 23.1.

164. *Id.*

165. *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Brody v. Chemical Bank*, 517 F.2d 932 (2d Cir. 1975); *In re Kauffman Mut. Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

166. *Smith v. Sperling*, 354 U.S. 91 (1957).

167. *Doctor v. Harrington*, 196 U.S. 579 (1905).

168. *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Ash v. International Business Machs., Inc.*, 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966).

169. *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917).

170. 404 F. Supp. 1172 (S.D.N.Y. 1975).

171. 15 U.S.C. § 80a (1976).

172. *Id.* § 80b.

173. 404 F. Supp. at 1176.

terminate the action.¹⁷⁴ The district court held that because the federal laws that were involved did not explicitly provide for a private action, the strong federal policies underlying the acts did not bar a board from exercising its business judgment in determining whether or not to prosecute the alleged cause.¹⁷⁵ The court also noted that the question of the proper use of business judgment was distinct from the question of ratification,¹⁷⁶ and that in the past, both state and federal courts have permitted termination of derivative suits involving claims that were arguably nonratifiable.¹⁷⁷ Lastly, the court found that the good faith business judgment of a genuinely disinterested minority not to pursue a cause of action was sufficient under law and was final.¹⁷⁸ The district court later granted summary judgment against the plaintiff, finding that there was no evidence that the minority of the directors had not acted independently and in good faith.¹⁷⁹ The court of appeals reversed, noting that the alleged violation of a federal law precluded disinterested directors from terminating a cause of action.¹⁸⁰ The United States Supreme Court, however, reversed the court of appeals and remanded¹⁸¹ the cause for determination under a proposed two-tier test: first, whether applicable state law permits the dismissal of a derivative action under the business judgment rule;¹⁸² and secondly, whether such a dismissal is consistent with the policy underlying the Investment Company and Advisors Act.¹⁸³ The Court did note that under the federal statutes in question Congress did not require that state or federal courts absolutely forbid director termination of all nonfrivolous actions.¹⁸⁴ This observation, therefore, indirectly ratified the district court's determination that the courts might apply the business judgment rule to issues that involve allegations of illegal activities.¹⁸⁵

Only two state courts¹⁸⁶ have addressed the issue of the applicability of the business judgment rule to the dismissal of derivative actions against

174. *Id.* at 1177.

175. *Id.* at 1179-80.

176. *Id.* at 1180.

177. *Id.*

178. *Id.* at 1179.

179. 426 F. Supp. 844 (S.D.N.Y. 1977).

180. 567 F.2d 1208 (2d Cir. 1977).

181. 441 U.S. 471, 486 (1979).

182. *Id.* at 480.

183. *Id.*

184. *Id.*

185. A similar use of the business judgment rule is noted in the earlier district court decision in *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976), in which a shareholder derivatively sued directors of Exxon for making what were alleged to be illegal payments to a foreign government. The District Court for the Southern District of New York held that in the absence of a showing of fraud, collusion, self-interest, dishonesty, or other breaches of trust, and in the absence of a demonstration that the use of business judgment was tantamount to gross negligence, the court would not interfere with the judgment of disinterested directors to terminate a cause of action. *Id.* at 516. The court noted that "the conclusive effect of such a judgment cannot be affected by the allegedly illegal nature of the original action which purportedly gives rise to the cause of action." *Id.* at 518.

186. *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

defendant-directors. In *Maldonado v. Flynn*¹⁸⁷ the Delaware Court of Chancery held that under Delaware law the rule could not shield the decision of disinterested directors to dismiss actions against other board members.¹⁸⁸ The court noted that through a derivative action, a shareholder seeks to compel a corporation to institute legal actions in its own behalf and that the shareholder's right to compel action cannot be defeated under the rule.¹⁸⁹ The court conceded, however, that use of the business judgment rule is appropriate to dismissal of derivative suits against noncorporate defendants and is available to directors defending a derivative action as a defense going to the merits of an action.¹⁹⁰

In *Auerbach v. Bennett*,¹⁹¹ a decision prior to *Lasker*, the New York Court of Appeals noted that under New York law the decision whether to pursue an action rests with the corporation and, consequently, is within the judgment and control of the board of directors.¹⁹² Unlike the *Maldonado* court, the New York Court of Appeals made no distinction between actions against corporate and noncorporate defendants. The court, however, did note that the business judgment rule should shield the "deliberations and conclusions of the chosen representatives of the board only if they possess a disinterested independence and do not stand in a dual relation

187. 413 A.2d 1251 (Del. Ch. 1980).

188. *Id.* at 1261-62. *Maldonado* was followed in *Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980) (construing Delaware law). *But see* *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980) [hereinafter referred to as *Maldonado-Fed*], in which a federal district court, dealing with the same litigants and disputes as did the Delaware Court of Chancery, held that Delaware law did permit dismissal of derivative actions against directors under the business judgment rule. Based on the res judicata effects of *Maldonado-Fed*, the Delaware Court of Chancery subsequently dismissed the action in *Maldonado*, but stayed the dismissal pending appeal of the federal decision. 417 A.2d 378 (Del. Ch. 1980). For cases in accord with *Maldonado-Fed*, see *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); *Abramowitz v. Posner*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,921 (S.D.N.Y. Mar. 25, 1981).

189. 413 A.2d at 1261-62.

190. *Id.* at 1256, 1258-60. In making the distinction between corporate and noncorporate defendants the court relied on *Cantor v. Sachs*, 162 A. 73, 73 (Del. Ch. 1932), in which the chancery court recognized the right of a shareholder to pursue an action in instances in which the corporation will not sue because it is dominated by alleged wrongdoers. The reasoning of the *Cantor* court, however, appears to address the potential for a lack of good faith in the decision to dismiss and does not bar per se the use of the rule when directors are defendants. *Abramowitz* criticized *Maldonado*, noting that the chancery court presented no logical basis for the distinction between corporate and noncorporate defendants, and would "render meaningless" the demand requirement under the Delaware rules of civil procedure. [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,921, at 90,691-92.

191. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

192. 47 N.Y.2d at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 927; *accord*, *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980) (construing Texas law); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (construing California law); *Grossman v. Johnson*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,950 (D. Mass. Apr. 7, 1981) (construing Maryland law); *Abramowitz v. Posner*, [1981 Transfer Binder] FED. SEC. L. REP. ¶ 97,921 (S.D.N.Y. Mar. 25, 1981) (construing Delaware law); *Genzer v. Cunningham*, 498 F. Supp. 682 (E.D. Mich. 1980) (construing Michigan law); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980) (construing Delaware law). *Contra*, *Abella v. Universal Leaf Tobacco Co.*, 495 F. Supp. 713 (E.D. Va. 1980) (construing Virginia law); *Maher v. Zapata Corp.*, 490 F. Supp. 348 (S.D. Tex. 1980) (construing Delaware law); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980) (construing Delaware law).

which prevents an unprejudicial exercise of judgment."¹⁹³ Thus, the New York court perceived the relevant issue to be the good faith and disinterestedness of the directors who seek dismissal and not the authority of such directors to do so.¹⁹⁴

A number of federal courts, following the *Lasker* inquiry, have examined whether dismissal of derivative actions under the business judgment rule would contravene policies underlying federal law.¹⁹⁵ Decisions that deal with alleged violations of the proxy disclosure provisions of section 14(a) of the Securities Exchange Act of 1934 are of particular significance.¹⁹⁶ The Supreme Court has recognized an implied private right of action under this section in favor of shareholders who have been injured as a result of false or misleading proxy solicitations.¹⁹⁷ In *Abbey v. Control Data Corp.*¹⁹⁸ a shareholder sought damages under section 14(a), claiming that the failure of Abbey's directors to disclose allegedly illegal foreign payments caused him injury. In affirming¹⁹⁹ the district court's dismissal of the action under the business judgment rule, the court noted that a plaintiff must demonstrate "transactional causation" as an essential element of a section 14(a) cause of action.²⁰⁰ The court held that any injury to plaintiff-shareholder was caused by the waste of corporate assets and not by "allegedly misleading proxy solicitations dealing with unrelated corporate business matters."²⁰¹ Accordingly, the shareholder claim was deemed to be only "marginally related" to the policies underlying the dis-

193. 47 N.Y.2d at 631, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927.

194. *Id.* The plaintiff claimed that the appointment by the defendant directors of a special committee to rule on the advisability of potential litigation was sufficient evidence that members of the committee could not function independent of the board. 47 N.Y.2d at 632, 393 N.E.2d at 1001, 419 N.Y.S.2d at 927. The court, in rejecting this argument, viewed the risk of "hesitancy" of board members to initiate litigation against members of its own peer group "inescapable." 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. Additionally, the court noted that to accept plaintiff's argument would be to disqualify the entire board from making the type of managerial decision traditionally entrusted to board action. *Id.* But see *Galif v. Alexander*, 615 F.2d 51 (2d Cir. 1980), in which the Second Circuit remanded for determination as to whether, under Ohio law, defendant directors who have ratified an allegedly illegal transaction but who have not benefited from that transaction, were sufficiently impartial to seek dismissal.

195. See, e.g., *Gaines v. Haughton*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,000 (9th Cir. May 18, 1981) (§ 14(a) of Securities Exchange Act of 1934); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980) (§ 14(a) of Securities Exchange Act of 1934); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (§ 10(b) of Securities Exchange Act of 1934); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979) (§§ 13(a), 14(a) of Securities Exchange Act of 1934), *cert. denied*, 444 U.S. 1017 (1980); *Grossman v. Johnson*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,950 (D. Mass. Apr. 7, 1981) (Investment Company Act); *Abramowitz v. Posner*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,921 (S.D.N.Y. Mar. 25, 1981) (§ 10(b) of Securities Exchange Act of 1934); *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980) (§ 14(a) of Securities Exchange Act of 1934).

196. 15 U.S.C. § 78(n) (1976).

197. *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

198. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

199. 603 F.2d at 732.

200. *Id.* The court noted, in addition, that a number of courts have refused to find a federal remedy under § 14(a) for illegal foreign payments by corporations. *Id.* See, e.g., *In re Tenneco Sec. Litigation*, 449 F. Supp. 528 (S.D. Tex. 1978).

201. 603 F.2d at 732.

closure requirements of section 14(a).²⁰²

In contrast, the Second Circuit Court of Appeals in *Galef v. Alexander*²⁰³ concluded that a section 14(a) claim was not subject to dismissal under the business judgment rule.²⁰⁴ The court reasoned that because the purpose of section 14(a) was to prevent management from obtaining authority for corporate action by means of deceptive or misleading proxy solicitations, a denial of a derivative right might frustrate "a type of enforcement that is essential to the accomplishment of the goals of [this section]."²⁰⁵ The *Galef* dispute, however, involved dismissal by defendant-directors who had not benefited from the challenged transaction but who had ratified it. Whether the Second Circuit would extend this holding to situations in which nondefendant directors seek termination of actions against other board members, therefore, is not clear.²⁰⁶

Despite the growing prominence of Texas as a regional corporate base, few Texas cases have addressed questions of director standard of care, negligent mismanagement, and business judgment. Nevertheless, the clear view of those few courts that have confronted these issues has paralleled those of other jurisdictions. In one early case, *Cates v. Sparkman*,²⁰⁷ the Texas Supreme Court stated the standard for judicial interference in derivative actions as follows:

[I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.²⁰⁸

Thus, despite the ordinary care standard set forth in the *McCullum*²⁰⁹ decision, Texas courts consistently have followed the *Cates* requirement that liability should attach to a director's action only if the action is ultra vires

202. *Id.* In reaching the same conclusion, the Ninth Circuit Court of Appeals noted that "[s]o long as those accused of manipulating the proxy vote are excluded from deciding whether or not to pursue the claim there is no conflict between the business judgment rule and § 14(a)." *Lewis v. Anderson*, 615 F.2d 778, 784 (9th Cir. 1979). Thus, the Ninth Circuit avoided addressing the issue of § 14(a) policies and demanded only that the decision to dismiss be made by disinterested directors. This conclusory treatment of the second tier of the *Lasker* inquiry is apparent also in the holding in *Maldonado v. Flynn*, 485 F. Supp. 274 (S.D.N.Y. 1980). The *Maldonado-Fed* court did stress, however, that plaintiff was free to pursue an independent claim, so that dismissal of the derivative action did not preclude the litigation of claims against defendant-directors. 485 F. Supp. at 281.

203. 615 F.2d 51 (2d Cir. 1980).

204. *Id.* at 53.

205. *Id.* at 63. The court noted that in many instances the derivative suit may be the only practical means available to shareholders to vindicate harms accruing from director mismanagement. *Id.*

206. See Block & Barton, *The Business Judgment Rule as Applied to Stockholders Proxy Derivative Suits Under the Securities Exchange Act*, 8 SEC. REG. L.J. 99, 112 (1980).

207. 73 Tex. 619, 11 S.W. 846 (1889).

208. *Id.* at 622, 11 S.W. at 849.

209. *McCullum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding adopted).

or is based in fraud.²¹⁰ Texas courts have applied this requirement not only to derivative suits²¹¹ but also to suits that corporate representatives institute.²¹²

In Texas and other jurisdictions, the majority of actions that allege negligent mismanagement are filed through the device of the derivative suit. The application of the business judgment rule, however, forces a plaintiff-shareholder to confront a two-tier barrier to legal redress. First, he must be prepared to establish that a director's action was grossly negligent, despite the legal requirement that directors must act with ordinary care. Secondly, he must be prepared to demonstrate that allegedly disinterested directors have in fact acted collusively or fraudulently in refusing his demand to prosecute offending directors or officers. Thus, the business judgment rule serves not only as a defense for defendant directors but also as a presumption against the standing of plaintiff-shareholders to proceed in an action against directors. This double requirement presents a formidable barrier to aggrieved shareholders and it is difficult to avoid the conclusion that the business judgment rule may serve as an effective shield against allegations of a breach of fiduciary duty. In effect, the rule not only modifies the standard of care that case law and statutes developed, but also represents a judicial abdication of the court's role in determining whether a director has violated his legal duties to the corporation and its shareholders.

V. MODERN TRENDS: WILL DIRECTORS BE HELD MORE ACCOUNTABLE?

The modern realities of corporate organization require that an outside director function not to manage the corporation, but to oversee management decisions of corporate officers and employees. An evaluation of a director's performance, therefore, should focus primarily on the degree of effectiveness with which he monitors the decisions of the executive stratum. The business judgment rule, by negating the fiduciary requirement for due care, has obscured the legal requirements necessary to guide the oversight function and, accordingly, has insulated directors from liability for the negligence of those to whom they have delegated a board function.

In sharp contrast, the growing tendency under federal securities law is to

210. See *Robinson v. Bradley*, 141 S.W.2d 425 (Tex. Civ. App.—Dallas 1940, no writ); *Bounds v. Stephenson*, 187 S.W. 1031 (Tex. Civ. App.—Dallas 1916, no writ); *Caffall v. Bandera Tel. Co.*, 136 S.W. 105 (Tex. Civ. App. 1911); *Farwell v. Babcock*, 65 S.W. 509 (Tex. Civ. App. 1901). See also *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.).

211. *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980). The Fifth Circuit held that the decision whether to pursue a corporate cause of action is part of the "business and affairs" . . . that corporate directors primarily manage." *Id.* at 52 (citations omitted).

212. *Jewell v. Sal-O-Dent Laboratories*, 69 S.W.2d 544 (Tex. Civ. App.—Eastland 1934, writ ref'd); *New Birmingham Iron & Land Co. v. Blevins*, 34 S.W. 828 (Tex. Civ. App. 1896, no writ).

hold outside directors more accountable for management decisions.²¹³ This trend is illustrated in the decision of a federal district court in *Escott v. BarChris Construction Corp.*,²¹⁴ which involved allegations that registration statements for BarChris stock contained material misrepresentations and omissions in violation of section 11 of the Securities Act of 1933.²¹⁵ One outside director adopted the defense that, in view of his recent appointment to the board, he had reasonably relied on the opinions of executive officers regarding the accuracy of nonexpert portions of the registration statement.²¹⁶ In rejecting this due diligence defense the court stated that:

A director is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own company. A prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsibility merely because they are new.²¹⁷

Some commentators have said that *BarChris* added nothing to the guidelines for evaluating director functions.²¹⁸ Others, however, see the decision as reviving standards of care that the courts have discarded for sometime.²¹⁹ The decision has caused concern on the part of outside di-

213. This sentiment was expressed by A.A. Sommer, Jr., Commissioner of the Securities and Exchange Commission, who stated:

The elevation of standards of conduct in society is invariably accompanied by stresses and forebodings and exaggerated fears of the consequences of reaching to higher levels of performance. It is not surprising that, as the developing concepts of federal securities law reach out to touch corporate directors, there should be tremors and concerns. And yet, out of all of this there will surely come greater awareness of the importance of conscientious conduct by corporate fiduciaries and greater attention to the responsibilities which are assumed when one becomes a director.

quoted in J. BACON & J. BROWN, *supra* note 27, at 82. See also Sommer, *Directors and the Federal Securities Laws*, [1974] FED. SEC. L. REP. (CCH) ¶ 79,669.

214. 283 F. Supp. 643 (S.D.N.Y. 1968). See also *Mitchell v. Texas Gulf Sulfur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

215. Section 11 of the Securities Act imposes liability upon the issuer of securities and certain designated persons when a registration statement contains an untrue statement of a material fact or an omission of a material fact. 15 U.S.C. §§ 77(a)(1)-(5) (1976).

216. The Act provides a "due diligence" defense as to nonexpert and expert portions of a registration statement. In regard to nonexpert portions a defendant must establish that he made a reasonable investigation of the facts presented and that he had reasonable grounds for believing that the statement was accurate and complete. The standard by which reasonable investigation and reasonable ground for belief is evaluated is "that required of a prudent man in the management of his own property." 15 U.S.C. § 77k(c) (1976). The standards governing expert portions of the statement are set forth in 15 U.S.C. §§ 77k(b)(3)(B)-(D) (1976).

217. 283 F. Supp. at 688.

218. See Cohen, *The Opinion*, 24 BUS. LAW. 550 (1969).

219. Kaplan, *Panel Discussion*, 24 BUS. LAW. 611 (1969); Shaneyfelt, *The Personal Liability Maze of Corporate Directors and Officers*, 58 NEB. L. REV. 692 (1979).

rectors as to their potential liabilities under federal law.²²⁰ As a result, many corporations have begun to reexamine the role of the outside director and have implemented measures to ensure a clearer definition of board members' duties.²²¹ Among the most notable of these measures is the institution of independent audit committees.²²² First proposed by the Securities and Exchange Commission in 1940,²²³ the audit committee is composed primarily of independent directors who evaluate management decisions with information that independent auditors supply. The committee is designed to maximize the effectiveness of a board's monitoring function by providing access to unbiased information. The directive to evaluate this information presumably would avoid the result in *BarChris*.

The impact that *BarChris* and other securities decisions will have on the delegation function in the American corporation is not clear-cut. Corporate directors are becoming increasingly sensitive to the potential liabilities that accrue from a broad interpretation of federal regulatory schemes and, consequently, are more eager to have their duties clearly defined. Nevertheless, the recent applications of the business judgment rule to shareholder derivative suits represent a consistent judicial reluctance to define the legal obligations of a corporate director. The conflict arising from these two positions may lead to a general redefinition of directorial function, but at the moment, both directors and shareholders must suffer the consequences of this indecision.

VI. CONCLUSION

Under the business judgment rule a director who acts in good faith and in the best interests of his corporation will not be held liable for mistakes of business judgment that damage corporate interests. The rule requires that a director act with attention to his fiduciary duties of good faith and loyalty but avoids a requirement that he act with due care. Under the rule, therefore, a director will be held liable only upon proof of fraud, bad faith, or gross negligence. This result is inconsistent with common law and statutes that require directors to act with ordinary care in the conduct of their offices and may reflect both a judicial refusal to evaluate corporate affairs and the considerable confusion that exists as to the precise legal responsi-

220. W. CARY & M. EISENBERG, *supra* note 59, at 1313.

221. See generally *Guidebook*, *supra* note 65.

222. In 1974, 80% of 1083 companies listed on the New York Stock Exchange had audit committees in operation. W. KNEPPER, *supra* note 42, at 29. Since 1978 the Stock Exchange has required all listed companies to have audit committees. *Id.* See also Release No. 13346, 11 SEC DOCKET 1945 (Mar. 9, 1977).

223. In the Matter of McKesson & Robbins, Inc.—*Summary of Findings and Conclusions*, Accounting Series Release No. 19 (Dec. 5, 1940), cited in W. KNEPPER, *supra* note 42, at 29. The recommendation was addressed to all publicly held corporations. See also *Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices*, [1976] SEC. REG. & L. REP. (BNA) No. 353 (Special Supp. May 19, 1976). The report, submitted to the Senate Banking, Housing and Urban Affairs Committee, proposed a system of internal audit procedures designed to restore the "efficacy of the system of corporate accountability." [1976] SEC. REG. & L. REP. (BNA) No. 353, at 2.

bilities of directors, particularly outside directors. Recent applications of the business judgment rule to derivative actions indicate that shareholders face an almost insurmountable barrier to establishing the liability of directors under allegations not only of negligence but also of illegal activities. In contrast, recent developments under federal securities law indicate a demand that outside directors be held more accountable for their official actions. These developments have initiated attempts to define more precisely the scope of directorial function. At the moment, however, directors continue to hold office under obscure guidelines, and shareholders face uncertain and unsatisfactory results when they seek legal redress for harms to corporate interests.