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Cindy A. Schipani
University of Michigan

Cindy A. Schipani, Associate Professor, University of Michigan. The author gratefully acknowledges the research support of the University of Michigan

THE DUTY OF CARE STANDARD IN CORPORATE GOVERNANCE: A COMPARATIVE ANALYSIS OF THE U.S. AND AUSTRALIAN EXPERIENCES

by

Cindy A. Schipani*

Directors of corporations in the United States and Australia are required to act with due care with respect to corporate affairs. Yet, successfully proving a violation of due care has not been a simple task in either country. Absent fraud or bad faith, directors of both U.S. and Australian corporations are presumed to have acted in good faith and in the best interests of the corporation. As a result, courts in both countries have been generally reluctant to second-guess good faith business decisions and have only rarely held directors monetarily liable for breach of the duty of care. Cases which prove to be the exception to the rule have involved the director's failure to obtain reasonably available information before making a business decision, or failure to adequately supervise corporate affairs. In most other circumstances, directors generally have not been held liable for due care violations in making business decisions, absent fraud, self-dealing or evidence of gross negligence.

In the mid-1980s, the pendulum began to swing the other way in the United States when the Delaware Supreme Court strengthened the duty of care standard. In 1986, the Delaware Supreme Court decided the case of *Smith v. Van Gorkom*,[1] and held the directors of Trans Union Corporation liable for breach of the duty of care. The court found that these directors failed to obtain all reasonably available information regarding the true intrinsic value of the corporation before voting in favor of a merger proposal and were thus grossly negligent in violation of the duty of care.

The roar of due care in the U.S. was short-lived, however. Although every state requires corporate directors to act with due care, over forty jurisdictions have adopted mechanisms whereby corporations may exonerate directors from monetary liability for its breach. The effect of this legislation thus dilutes whatever strength the standard once had. Corporations in nearly every jurisdiction may exonerate directors from monetary liability to the corporation and its shareholders for due care violations, even if the directors were grossly negligent. The duty of care standard in corporate governance has therefore suffered a major setback in the United States.

The current direction of Australian law is, on the other hand, quite different. In fact, the duty of care standard as codified in the Corporations Law Reform Act 1992 (the "1992 Act") appears to strengthen rather than weaken the standard. Subsection 232(4) of the 1992 Act requires directors to "exercise a reasonable degree of care and diligence in the exercise of powers and discharge of their duties" while subsection 232(7) expressly provides for civil recovery for its breach. Moreover, the standard is an objective one and directors are not entitled to the benefits of a business judgment rule.

This paper seeks to compare and to analyze the U.S. and Australian experiences and is organized as follows. Part IA begins with an analysis of the duty of care standard as it has evolved in United States common and statutory law, with consideration of the development the business judgment rule. Part IB addresses the impact of the *Smith v. Van Gorkom* decision on the U.S. experience culminating in Part IC with a discussion of the exculpatory legislation enacted in its aftermath. A brief history of the Australian experience is then presented in Part IIA together with a description of Australia's latest effort at corporate reform in Part IIB. A lesson from the U.S. experience and concluding remarks are then offered in Parts III and IV, respectively.

I. THE DUTY OF CARE STANDARD IN THE UNITED STATES: A BRIEF HISTORY

A. General Corporate Law Rule: Reasonable Care

Corporate governance officials are required by law in every jurisdiction to act with due care with respect to corporate affairs. The Model Business Corporation Act states that a director must exercise "the care an ordinarily prudent person in a like position would exercise under similar circumstances."[2] The American Law Institute (the "ALI") has proposed a similar standard in its Proposed Final of the Restatement of Corporate Governance.[3] The formulations of the duty of care under the common law have ranged from requiring directors to act as ordinarily prudent persons would, acting under similar circumstances in the conduct of their own affairs[4] to simply requiring avoidance of gross negligence.[5] Many states have codified the duty of care standard.[6]

One aspect of the duty of care is the duty to be informed.[7] This duty has been expressed as encompassing two elements: (1) "alertness to potentially significant corporate problems"[8] and (2) "deliberative decision making on issues of fundamental corporate concern."[9] In *Francis v. United Jersey Bank*,[10] for example, a director was held personally liable by the New Jersey Supreme Court for losses caused by the fraudulent acts of the corporate officers because of her inattentiveness to corporate affairs.[11] She had not read the firm's financial statements, which on their face would have disclosed the fraud, and knew virtually nothing about the corporation's affairs.[12] The duty of care standard thus requires members of the board to monitor the activities of management and not act merely as a rubber stamp.[13]

Although the director has a fiduciary obligation to exercise due care, it is not necessary for the director to personally investigate every matter before the board. Section 141(c) of the Delaware Code specifically permits the board of directors to designate committees to exercise the authority of the board in the management of the corporation.[14] Section 141(e) permits the members of the board, acting in good faith, to rely upon corporate records and upon reports of officers, employees, committees, or other competent professionals.[15] The opinions of experts and professionals may be relied upon only if the experts and professionals have been selected with reasonable care.[16]

Yet, the director's reliance upon the opinions of others should not be given blindly. A director has not acted in good faith if he or she has knowledge which would cause reliance to be unwarranted.[17] This limitation on section 141(e) is exemplified by the *Smith v Van Gorkom* decision.[18] In *Van Gorkom,*[19] the board relied upon a 20-minute presentation of the chairman and chief executive officer regarding his merger recommendation.[20] The court held that the directors' reliance on the presentation was not justified[21] because reasonable inquiry would have revealed flaws in the proposal.[22] Thus, although section 141(e) tempers the duty of care by permitting directors to rely upon the reports of others, due care must still be exercised in deciding whether reliance upon the advice of an expert is justified.

Notwithstanding the duty of care standard, the American Law Institute has noted that since the turn of the century directors have been found to have violated their duty of care obligations in approximately only thirty cases.[23] Professor Bishop has commented that the search for cases where directors have been held liable to shareholders in derivative suits for mere negligence is like searching for a needle in a very large haystack.[24] This may be due in part to the protections afforded corporate directors by the business judgment rule. Absent fraud or bad faith, the business judgment rule grants directors the benefit of a presumption that in making business decisions they have acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.[25] Thus, although the duty of care standard is defined in terms of simple negligence, courts have generally refrained from finding directors liable for negligent business decisions,[26] citing the business judgment rule.[27]

There are, however, limitations on the application of the business judgment rule. The first limitation[28] is that there be no conflict of interest between the director and the corporation, *i.e.*, no breach of the duty of loyalty.[29] Second, directors must fulfill their obligation to inform themselves of all material information reasonably available before making the business decision, and act with the requisite care in performing their duties.[30] Subject to these limitations, directors generally will not be liable for breach of the duty of care.[31]

B. *Smith v. Van Gorkom*: Strengthening the Standard of Due Care

In 1986, the Delaware Supreme Court decided a case that would have far-reaching consequences on the standard of care in the United States. Ironically, although initially strengthening the due care standard, the decision led to its dilution only eighteen months later. This decision, *Smith v. Van Gorkom,* [32] involved a class action brought by shareholders of the Trans Union Corporation (Trans Union or the Company) against its directors.[33] The shareholders sought damages resulting from the cashout merger of their corporation.[34]

In holding the directors liable for breach of the duty of care, the court decided that the business judgment rule did not apply because the directors had not fully informed themselves before making the merger decision.[35] The court appeared troubled by the process by which the board reached its decision.[36] The board deliberated for only two hours after a twenty-minute presentation given by Van Gorkom.[37] Most of the directors had no prior knowledge of the purpose of the meeting, nor did they have any documents before them concerning the proposed transaction.[38] The board did not request an evaluation study or documentation justifying the $55 price.[39] No one questioned the chief financial officer regarding why he considered the $55 originally offered a fair price.[40] Furthermore, the court found that "Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking."[41]

The court thus found the directors grossly negligent for failing to ascertain the true intrinsic value of the company before presenting a merger proposal to the shareholders.[42] Plaintiffs sought over $100 million in damages. The Delaware Supreme Court found evidence of gross negligence and remanded the case to the Court of Chancery on the issue of damages. The case reportedly settled for $23.5 million,[43] only $10 million of which was covered by the directors' and officers' ("D&O") liability insurance policy.[44]

The *Van Gorkom* decision was controversial. Some commentators argued that the decision was correctly decided and agreed with the court's conclusion of gross negligence[45] while others contended that the evidence did not warrant this finding.[46] In any event, the decision seemed to evidence a change in Delaware law tightening the legal constraints on directors.

C. State Exculpatory Legislation: Relaxing the Standard of Due Care

In the wake of the *Van Gorkom* decision, premiums for D&O liability insurance skyrocketed to a point where many corporations were unable to afford adequate coverage.[47] The Delaware legislature became concerned that qualified people would refuse to serve on boards of directors because of fear of personal monetary liability.[48]

The legislature thus enacted Section 102(b)(7) of the Delaware Code to relax liability for breach of the standard of care and enable corporations to opt out of the *Van Gorkom* decision. A majority of states have followed Delaware's lead and have enacted legislation insulating corporate directors from liability for negligence. All of these statutes exonerate directors from monetary liability to the corporation and its shareholders for acts of simple negligence (except in cases of improper payment of dividends) and most of the statutes provide exculpation for acts of gross negligence. Thus, although the directors' duty of care is codified in most states in terms of a simple negligence standard, most states provide the corporation with the means to limit or eliminate the directors' monetary liability exposure to the corporation and its shareholders for acts of negligence.

1. The Delaware Model

The model for state exculpatory legislation is Section 102(b)(7) of the Delaware Code.[49] Section 102(b)(7) became effective in 1986 and permits Delaware corporations to include the following provision in their articles of incorporation:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section the certificate of incorporation may also contain any or all of the following matters - (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this Title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.[50]

2. Other Types of Exculpatory Legislation

Not all states restrict exculpation to directors. In Louisiana,[51] Maine,[52] Maryland,[53] Nevada,[54] New Hampshire,[55] New Jersey[56] and Virginia,[57] officers may also be protected from monetary liability for simple negligence. Moreover, not all jurisdictions require corporations to include exculpatory language in their articles of incorporation. Florida,[58] Indiana,[59] Maine,[60] Ohio[61] and Washington[62] provide exculpation automatically and Wisconsin[63] limits liability unless the articles of incorporation provide otherwise. Hawaii,[64] Utah[65] and Virginia[66] permit exculpatory language in the corporate by-laws and Utah[67] even permits such language in a resolution. Pennsylvania requires that the provision be contained in the by-laws.[68]

By far, the most common exculpatory statute is modeled after the Delaware legislation and requires the exculpatory language to be included in the articles of incorporation, protects directors only, and prohibits exculpation for breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, knowing violation of law, improper payment of stock dividends or transactions in which the director receives an improper personal benefit.[69] This is in contrast to the recent reforms in director liability standards in Australia. The Australian duty of care standards are discussed below.

II. THE DUTY OF CARE STANDARD IN AUSTRALIA: A BRIEF HISTORY

A. General Corporate Law Rule: Reasonable Care

Directors of corporations in Australia have been historically held to a standard of care similar to that of directors of U.S. corporations. Both U.S. and Australian directors are required to exercise reasonable care with respect to corporate affairs.[70] The standard of care in Australia is "to be measured by the care that an ordinary man might be expected to take in the circumstances upon his own behalf."[71] Moreover, the duty of care in Australia has been applied so that the director's liability has been primarily limited to acts of gross negligence.[72] Like the duty of care in the United States, the duty of care in Australia runs in favor of the corporation. But unlike the duty in the United States, the Australian duty of care runs only in favor of the corporation and not in favor of the shareholders.[73]

The Australian directors' duty of care comprises the following three elements: "(1) the standard of skill against which the director's performance is measured; (2) a duty of diligent participation in board affairs; and (3) the right of directors to delegate the discharge of duties to company officials and to assume reliable performance."[74] The first element, relating to the standard of skill, appears more lenient than its U.S counterpart. Australian directors have only been required to act with the care that could be reasonably expected from a person with his or her knowledge and experience.[75] In fact, it has been said that the director is required to "do only as much as one might fairly expect of someone as stupid and incompetent as the director happens to be."[76] This is in contrast to the fairly uniform standard of care in the United States requiring directors to exercise the degree of care of the reasonably prudent person, acting under similar circumstances.

The second and third components of the Australian duty of care standard mirror the U.S. standard. As discussed above, directors in the U.S. are required to keep informed of corporate affairs.[77] This requirement is also true in Australia. The duty of diligent participation similarly requires the director to be familiar with corporate affairs.[78] But, at least with respect to non-executive directors, this burden is not particularly onerous. For example, the court in *Re City Equitable* stated that:

> A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings . . . . He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.[79]

Finally, as in the U.S., directors of Australian corporations are permitted to rely on information provided by others, assuming their reliance was reasonable.[80] Non-executive directors are given more latitude in this regard than are executive directors.[81] The right to rely on information provided by others extends to company officials, committees, the chairman of the board, and external advisors to the company, such as the company solicitor and the auditor.[82]

An Australian court recently addressed the issue of reasonable reliance in *AWA Ltd v. Daniels*.[83] In defending a claim of negligence, the company auditors in *AWA* alleged contributory negligence against the executive and nonexecutive directors. They were successful in their claims against the executive directors, but not in their claims against the nonexecutive directors. The nonexecutive directors defended the claim of contributory negligence on the grounds that they had relied upon management to carry out control of day-to-day affairs, to establish proper controls and accounting records, to communicate and implement board policies, to summarize information regarding contracts and financial affairs, to prepare the budget and to handle personnel matters. The court held that such reliance would be unreasonable if the directors were aware of :

> circumstances of such a character, so plain, so manifest and so simple of appreciation that no person, with any degree of prudence acting on his behalf, would have relied on the particular judgment, information and advice of the officers.[84]

The court found that the nonexecutive directors were entitled to rely upon management to implement and supervise board policies and therefore held that they did not breach their duty of care. The managing director, however, was not as fortunate. Concerns had been conveyed to the managing director regarding the adequacy of supervisory controls. Thus, the managing director's failure to act, when aware of the problem, resulted in his liability.

B. Corporate Reform: Strengthening the Standard of Due Care

One particularly notable characteristic of the Australian standard of care prior to the reforms of the 1992 Act was its subjectivity. The skill required of the Australian director has been stated to be simply the skill the person had. The U.S. standard appears at first glance to be stricter than the Australian standard, requiring the director to at least act as the reasonably prudent person would. Yet, as a practical matter, the Australian standard is really not much different from the standard of care in the United States after consideration of the business judgment rule. The business judgment rule, as applied by the courts in the U.S., gives the director the benefit of the presumption that he or she acted in good faith and in the best interest of the corporation and therefore prevents the courts from second-guessing the business acumen of the director. The business judgment rule in effect permits the U.S. courts to apply a rather subjective standard to the acts of the corporate officials. Thus, both the U.S. and the Australian standards of care appear to have been applied in a rather subjective manner and both result in very few cases of liability.

Australian corporate law reformers have attempted to strengthen the standard of care. The first exposure draft of the Uniform Companies Act in 1958 proposed a provision requiring the company officers to exercise "a degree of care, diligence and skill that is not less than the degree of care, diligence and skill that a reasonably prudent person would exercise in relation to his own business or affairs in comparable circumstances."[85] This clause was severely criticized as exacting an impossible standard and was promptly deleted.[86] The 1958 Act simply required directors to excercise reasonable care and diligence.[87]

The latest effort at reform, the 1992 Act, seems to have met with more success in objectifying and therefore purportedly strengthening the duty of care standard. Subsection 232(4) of the 1992 Act provides that:

> In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances.[88]

The term officer is broadly defined in subsection 232 (1)(a) to include corporate directors, secretaries and executive officers of the corporation.[89]

The original bill contained a clause outlining the factors to be used in determining whether the standards of diligence and care had been met. These factors included:

> (a) what information the officer acquired, and what inquiries the officer made about the corporation's affairs;
> (b) what meetings the officer attended;
> (c) how far the officer exercised an active discretion in the matters concerned;
> (d) what the officer did to ensure that the corporation made adequate arrangements:
>
> > (i) to ensure that people who prepared reports, or gave advice or opinions, on which officers or employees of the corporation relied were honest, competent and reliable, and were in other respects such as to inspire confidence in their reports, advice or opinions; and
> > (ii) to monitor and ensure compliance with the law, and with the corporation's constitution, by the corporation and its officers and employees; and
> > (iii) to ensure that persons who took part in the corporation's management did whatever was necessary to avoid a conflict of their pecuniary or other interests with the proper performance and exercise of their functions and powers; and
> > (iv) to ensure that decisions made by persons on the corporation's behalf were adequately monitored; and
> > (v) to ensure that persons who made decisions on the corporation's behalf had adequate information about the subject matter of the decisions;
>
> (e) what the officer did to ensure that arrangements of the kind referred to in paragraph (d) were given effect to and to any other relevant matter.[90]

Enactment of these factors was vigorously opposed by interested parties, such as the Australian Institute of Company Directors.[91] These factors were not enacted in the final 1992 Act.

The 1992 Act is less than one year old and thus only time will tell whether this standard will be interpreted by the courts as being any more stringent than the previous subjective standards of care, particularly in light of subsection 232(11) of the 1992 Act. Subsection 232(11) states that the duties in subsection 232 are in addition to, and not in derogation of, other duties and liabilities of corporate officers. Thus, the purportedly more objective standard exists side-by-side with the subjective standard of fiduciary duty. It will be interesting to see whether the courts find any conflict between the common law of fiduciary duty and statutory law.

Notably, enactment of the 1992 Act did not include codification of the U.S. business judgment rule. The Cooney Committee,[92] the Companies and Securites Law Review Committee[93] and the Lavarch Committee[94] all recommended codification of the business judgment rule into the 1992 Act. The Companies and Securites Law Review Committee recommended a business judgment rule that would protect judgments made in the conduct of business operations but not judgments concerning the company's constitution, conduct of meetings, appointment of executive officers or solvency.[95] The rationale of the Companies and Securities Law Review Committee in favor of a statutory business judgment rule was to "encourage business endeavour by assuring people who embark on business enterprises by specific legislation that if, acting honestly, they take risks there is some safeguard against personal liability flowing from tribunals reviewing with hindsight the merits of bona fide business decisions."[96] The Commonwealth opposed the business judgment rule.[97]

Thus, it appears, that the state of corporate law reform has diverged significantly in Australia from the United States. The majority of states in the United States have moved toward diluting their standard of care by permitting corporations to exculpate their directors from monetary liability for its breach, while the 1992 Act adopted by the Australian states provides an objective standard of care.

III. A LESSON FROM THE U.S. EXPERIENCE

As demonstrated above, breach of the duty of care standard in the United States has rarely resulted in personal liability. The presumption of good faith and honesty in corporate dealings provided by the business judgment rule has not been easily overcome. As applied by the courts since the early 1800's, it has been only occasionally successfully invoked against corporate officials in actions alleging mismanagment. Then, in the aftermath of a decision of the Delaware Supreme Court holding directors accountable for breach of the duty of due care, the legislature quickly responded and virtually eliminated all monetary liability to the corporation and its shareholders for due care violations short of intentional misconduct or self-dealing.

There is empirical evidence to suggest that the legislative reaction in the United States was not necessarily in the best interests of the shareholders. A study of the reaction in the stock prices of Delaware corporations, vis-a-vis corporations incorporated in other U.S. states both after the *Van Gorkom* decision and the Delaware exculpatory legislation concludes that Section 102(b)(7) had a statistically significant negative impact on the value of Delaware shares.[98] This study sought to empirically test the relative importance of market constraints and legal constraints on shareholder wealth.

The most important results of the empirical analysis are the abnormal returns to Delaware firms over the months surrounding the effective date of Section 102(b)(7).[99] The cumulative abnormal return to Delaware firms from June 1, 1986 through August 1, 1986 is -2.96% ($t = -2.61$).[100] The study also found that firms elect to adopt the provisions of Section 102(b)(7) after they have experienced a significant decline in the value of their equity securities.[101] In addition, the study found that the market reacts negatively to the announcement that a firm's management has elected to be covered by the provisions of the Delaware statute.[102]

The significant decrease in the relative value of Delaware firms both around the enactment of Section 102(b)(7) and when they elect to adopt the provisions of the statute indicate that relaxed liability exposure for violations of the duty of care standard allowed by Section 102(b)(7) has reduced the wealth of the stockholders of Delaware firms.[103] The results are consistent with the view that the new regime established by Section 102(b)(7) allows corporate managers greater latitude in managing their firms, which in turn increases the agency costs of the corporate form and reduces the value of the equity claims of these firms.[104] Thus, it appears that a lesson from the U.S. experience is that liability rules are a binding constraint on the behavior of corporate officials and that liability rules do matter.[105]

IV. CONCLUSION

Although it is premature to predict whether the 1992 Act will improve the duty of care standard in Australia, the limited evidence that exists from the U.S. experience suggests that the 1992 Act is probably moving in the appropriate direction. It remains to be seen, however, whether the Australian courts' interpretation of the 1992 Act will ultimately result in a better standard of care than exists in the United States.

As previously discussed, the United States began with a fairly objective standard of due care for upon corporate directors. This standard required the corporate director to act as the reasonably prudent person would, acting under similar circumstances.[106] This standard was, however, diluted in the case law with the juxtaposition of the business judgment rule. Courts were hesitant to second-guess the business decisions of corporate officials and afforded them the benefit of the presumption that their decisions were made in good faith and the honest belief that they were in the best interest of the corporation.[107] Thus, there are very few cases in the United States that have found directors liable for breach of the duty of care. Before imposing liability, the courts have generally required a finding of gross negligence or absolute neglect of corporate affairs.[108]

Although the Australian courts did not frame the duty of care in terms of an objective standard nor use a business judgment rule analysis, the duty of care standard prior to the 1992 reforms was similar to the standard in the United States. The Australian courts employed a standard of care requiring the director to act with reasonable skill considering his or her own knowledge and expertise.[109] Thus, the standard of care was quite subjective and resulted in only a few cases of liability.

Then in the United States, the Supreme Court of Delaware appeared to strengthen the standard of care when it found the directors of Trans Union Corporation in breach of their duty of care in failing to attain all reasonably available information before voting on a merger proposal.[110] The aftermath of this decision was dramatic. Corporate management decried the decision and convinced state legislatures to overrule it.[111] As a result, legislation was enacted permitting corporations to eliminate directors' monetary liability exposure to the corporation and its shareholders for due care violations.[112] The legislation weakens the liability standard even further than the regime that existed immediately prior to the *Trans Union* decision.

The 1992 reforms in Australia, on the other hand, appear to strengthen the standard of care. Rather than merely hold the director accountable for the degree of skill and knowledge that the director personally had, the 1992 Act requires the director to emulate the reasonably prudent person acting under similar circumstances.[113] This standard is the objective standard of care courts in the United States are familiar with. This standard, however, appears more stringent than its U.S. counterpart, due to its failure to provide corporate officials with the protections of the business judgment rule.

In light of the empirical evidence suggesting that the movement in the U.S. to eliminate director's monetary liability for due care violations may result in greater agency costs to the detriment of shareholders, it is possible that the Australian reformers may have taken the better approach. The move in the U.S. to completely eliminate monetary liability to the corporation and its shareholders does not appear empirically to be the optimal approach in reducing the agency costs of the firm. The limited empirical evidence that exists regarding the effect of the post *Trans Union* legislation on shareholder wealth suggests that the legislation had a statistically significant negative impact on the value of shares of Delaware corporations vis-a-vis corporations incorporated in other U.S. states.[114] A possible conclusion to be drawn from this evidence is that weak liability rules may result in increased agency costs within the firm.[115] In other words, liability rules may in fact be a significant constraint on the behavior of corporate managers.

It remains to be seen, however, whether the Australian reforms are more successful than the reforms in the United States. There are a number of unknown factors to consider. First, only time will tell whether the Australian courts will actually interpret the standard of care to be stronger than the pre-1992 Act reforms. The 1992 Act itself is somewhat ambiguous on this issue in its express provision incorporating, rather than overruling the standards of care that existed before the Act.[116] It is possible that the 1992 Act is not, in reality, any stricter than its predecessors.

Even if the Australian courts truly apply an objective standard of care, it is still not clear whether this is the optimal approach. For instance, this standard may be perceived as too harsh, particularly if the courts do not employ a business judgment rule analysis to the problem and Australia may ultimately experience a crisis similar to that experienced in the United States in the wake of the *Van Gorkom* decision. If so, competent people may begin to fear positions on corporate boards and the directors' and officers' liability insurance market may react severely. If a strict interpretation of the standard of care does indeed wreak havoc in the Australian corporate boardroom as it did in the United States, it is also possible that the Australian legislative bodies may consider a similar legislative response to that in the United States and swing the pendulum in the direction of eliminating monetary liability altogether.

Moreover, even if stricter liability standards do not result in the corporate upheaval described above, it is still not clear whether a strict objective standard of care is the optimal solution. Although the empirical evidence in the United States suggests that complete relaxation of liability is not optimal,[117] it does not necessarily follow that a strict objective standard of care is optimal. Market forces will still be in place to discipline the actions of corporate managers and to align their interests with corporate interests.[118] What is needed from the legal regime is a liability rule strict enough to prevent some of the agency costs that market forces do not, but lenient enough to encourage competent persons to serve on corporate boards and to take the risks necessary to engage the corporation in profitable projects. Hopefully, the lessons learned from the U.S. experience and the lessons soon to be gained from the Australian experience will assist in the development of an optimal liability regime in corporate governance.

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*Associate Professor, University of Michigan. The author gratefully acknowledges the research support of the University of Michigan.

1. *Smith v Van Gorkom* (Del 1985) 488 A2d 858.
2. Model Business Corp Act § 830 (1991) [hereinafter MBCA].
3. Principles of Corporate Governance and Structure: Analysis and Recommendations § 401(a) (Proposed Final Draft, 1992) [hereinafter PFD].

4. *See, eg, Hun v Cary* (1880) 82 NY 65, 71; *Selheimer v Manganese Corp of Am* (Pa 1966) 224 A2d 634, 640; *Hodges v New England Screw Co* (1850)1 RI 312, 348; *Williams v Fidelity Loan & Savings Co* (Va 1925) 128 SE 615, 623.
5. *See, eg, Godbold v Branch Bank* at Mobile (1847) 11 Ala 191, 200; *Percy v Millaudon* (La 1829) 8 Mart (ns) 68, 74-75, 78; *Bart Arconti & Sons v Ames-Ennis Inc* (Md 1975) 340 A2d 225, 236; *Nechis v Gramatan Garden, Inc* (Sup Ct 1962) 231 NYS2d 383, 385; *Spering's Appeal* (1872) 71 Pa 11, 24.
6. MBCA § 830 (1991) has provided the model for the codification of the duty of care standard in many states.
7. *See, eg, Aronson v Lewis* (Del 1984) 473 A2d 805, 812.
8. Cohn, SR, "Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule" (1983) 62 Tex L Rev 591, 613; *see* McMurray, MM, "Special Project Note, An Historical Perspective on the Duty of Care, the Duty of Loyalty and the Business Judgment Rule" (1987) 40 Vand L Rev 605, 611.
9. PFD, *supra* note 3.
10. *Francis v United Jersey Bank* (NJ 1981)432 A2d 814.
11. *Id* at 829.
12. *Id* at 819, 825-26, 829.
13. *See generally DePinto v Provident Sec Life Ins Co* (9th Cir 1967) 374 F2d 37, 45-46, *cert denied,* 389 US 822*; Heit v Bixby* (ED Mo 1967) 276 F Supp 217, 231; *Lutz v Boas* (Del Ch 1961) 171 A2d 381, 396.
14. Del Code Ann tit 8, § 141(c) (Supp 1988 & Supp 1992).
15. Del Code Ann tit 8, § 141(e) (1983 & Supp 1992).
16. *Ibid.*

17. Model Business Corp Act § 830(c) (1991); *see Francis v United Jersey Bank* (1981) 432 A2d 814, 825-26.

18. *Smith v Van Gorkom* (Del 1985) 488 A2d 858.

19. The facts of *Van Gorkom* are discussed more fully in Part IB below.

20. *Van Gorkom*, 488 A2d at 868, 874.

21. *Ibid.*

22. *Id* at p 875-77.

23. PFD *supra* note 3 at § 401 (a).

24. Bishop, Jr, J, "Sitting Duck and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers (1968) 77 Yale LJ 1078, 1099-1100.

25. *Aronson v Lewis* (Del 1984) 473 A2d 805 at 812; *see also Unocal Corp v Mesa Petroleum Co* (Del 1985) 493 A2d 946, 954; *Pogostin v Rice* (Del 1984) 480 A2d 619, 624-25; *Sinclair Oil Corp v Levien* (Del 1971) 280 A2d 717, 720; *Beard v Elster* (Del 1960) 160 A2d 731, 737; *Auerbach v Bennett* (NY 1979) 393 NE2d 994, 1000.

26. *See Aronson*, 473 A2d at 812 n6; Bishop, *supra* note 24, at p 1099.

27. *Miller v AT&T* (3d Cir 1974) 507 F2d 759, 762; *Aronson*, 473 A2d at 812 n 6; *Auerbach*, 393 NE2d at 1000; *Selheimer*, 224 A2d at 644; Bishop, *supra* note 24, at p 1095.

28. *Aronson v Lewis* (Del 1984) 473 A2d 805, 812.

29. *Ibid*; *see* Pease, DE, "*Aronson v Lewis*: When Demand is Excused and Delaware's Business Judgment Rule" (1984) 9 Del J Corp L 39, 63.

30. *Aronson*, 473 A2d at 812; Pease, *supra* note 29, at p 65.

31. *Aronson*, 473 A2d at 812 n6; Pease, *supra* note 29, at p 69.

32. 488 A2d 858 (Del 1985).

33. *Smith v Van Gorkom* (Del 1985) 488 A2d 858, 863.

34. The original plaintiff, Alden Smith, hoped to enjoin the merger. *Id* at 864 n1. After extensive discovery, Smith's motion for a preliminary injunction was denied by the trial court on Feb 3, 1981. The Trans Union stockholders approved the merger on Feb 10, 1981 and it became effective at that time. *Ibid.* John Gosselin then intervened as a plaintiff and the court certified Smith and Gosselin to represent the plaintiff class holding Trans Union stock on the relevant dates. *Ibid.*

35. *Id* at p 874.

36. *Id* at pp 874-78.

37. *Id* at p 874.

38. *Ibid.*

39. *Id* at p 877.

40. *Ibid.*

41. *Id* at p 875.

42. *Id* at p 893.

43. Manning, B, "Reflections and Practical Tips on Life in the Boardroom after *Van Gorkom*" (1985) 41 Bus Law 1, 1 n* (Editor's note).

44. Manning, *supra* note 43, at p 1 n* (Editor's note).

45. *See, eg,* Prickett, W, "An Explanation of Trans Union to "Henny-Penny" and Her Friends" (1985) 10 Del J Corp L 451, 463; Quillen, WT, "*Trans Union*, Business Judgment and Neutral Principles" (1985) 10 Del J Corp L 465, 466-480.

46. *See, eg,* Fischel, DR, "The Business Judgment Rule and the *Trans Union* Case" (1985) 40 Bus Law 1437, 1455; Herzel, L & Katz, L, "*Smith v Van Gorkom:* The Business of Judging Business Judgment" (1986) 41 Bus Law 1187, 1188-93; Herzel, L, et al, "*Smith* Brings Whip Down on Directors' Backs," *Legal Times*,

May 13, 1985, at p 14; Borden, AM, "First Thoughts on Decision in Delaware on *Trans Union*" NYLJ, Feb 25, 1985, at pp 1, 4-5.

47. *See, eg,* Foley, "The First Line of Director Defense" (Spring 1986) 10 Directors & Boards 15-16; Johnston, "Cause and Effects of the Liability Insurance Crisis, in Private Investors Abroad--Problems and Solutions in International Business in 1986" (J Moss ed 1986) at § 1188; Veasey, EN, Finkelstein, JA & Bigler, CS, "Responses to the D & O Insurance Crisis" (1986) 19 Sec & Commodities Reg 263, 263; Blank, SD, Note, "Delaware Amendment Relaxes Directors' Liability" (1987) 44 Wash & Lee L Rev 111, 118; "Insuring Directors" Mar 21, 1986, Wall St J, at p 31; "Business Struggling to Adapt as Crisis Spreads" Jan 21, 1986, Wall St J, at p 31; *see* Block, DJ, Barton, NE & Garfield, AE, "Advising Directors on D&O Insurance Crisis" (1986) 14 Sec Reg LJ 130, 130-31; Galante, MA, "The D&O Crisis: Corporate Boardroom Woes Grow" Aug 4, 1986, Nat'l LJ, at p 1; Olson, JF,"The D&O Insurance Gap: Strategies for Coping" Mar 3, 1986, Legal Times, at p 25.

48. *See Synopsis*, S533, 133d Gen Assembly (1986) [hereinafter *Synopsis*].

49. Del Code Ann tit 8, § 102(b)(7) (1991 & Supp 1992).

50. *Ibid.* Section 174 referred to in Section 102(b)(7)(iii) concerns proscriptions against the unlawful payment of dividends and unlawful stock purchases and redemptions. *Id* at § 174.

51. La Rev Stat Ann § 12:24 (c)(4) (West Supp 1992 & Supp 1993).

52. Me Rev Stat Ann tit 13A, § 716 (West 1981 & Supp 1992).

53. Md Corps & Ass'ns Code Ann § 2-405.2 (Supp 1991 & Supp 1992).

54. Nev Rev Stat § 78.037(1) (1991).

55. NH Rev Stat Ann § 292:2 (v-a) (Supp 1991 & Supp 1992).

56. NJ Stat Ann § 14A:2-7(3) (West Supp 1992 & Supp 1993).

57. Va Code Ann § 131-692.1 (Michie 1989 & Supp 1993).

58. Fla Stat ch 607.0831 (1991 & Supp 1992).

59. Ind Code Ann §§ 23-1-35-1(a), (e) (West 1989 & Supp 1992).

60. Me Rev Stat Ann tit 13A, § 716 (West 1981 & Supp 1991).

61. Ohio Rev Code Ann § 1701.59(B)(C) (Baldwin Supp 1991 & Supp 1993).

62. Wash Rev Code § 23B.08.320 (1989 & Supp 1991).

63. Wis Stat § 180.0828 (West 1992).

64. Haw Rev Stat § 415-48.5 (Supp 1991 & Supp 1992).

65. Utah Code Ann § 16-10a-841(1) (1992 & Supp 1993).

66. Va Code Ann § 13.1-692.1 (1989 & Supp 1993).

67. Utah Code Ann § 16-10a-841(1) (1992 & Supp 1993).

68. Pa Cons Stat Ann §§ 513, 1713 (Supp 1992 & Supp 1993).

69. Del Code Ann tit 8, § 102(b)(7) (1991 & Supp 1992). States with exculpatory legislation similar to the Delaware legislation include Alaska, Arizona, Arkansas, Colorado, Connecticut, Idaho, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, New Mexico, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas and Wyoming. California is somewhat similar, but also prohibits exculpation for acts not in the best interest of the corporation and actions showing a reckless disregard for corporate interests or an unexcused pattern of inattention. *See also,* Schipani, CA,"Integrating Corporate Law Principles with CERCLA Liability for Environmental Hazards" (1993) 18 Del J Corp L 1, 21; Schipani, CA, "Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act" (1992) 17 J. of Corp. Law 739, 752-756;

Bradley, M & Schipani, CA, "The Relevance of the Duty of Care in Corporate Governance" (1989) 75 Iowa L Rev 1, 72.

70. *See* Redmond, P, "The Reform of Directors' Duties" (1992) 15(1) UNSW LJ 86, 97.

71. *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 at 437 *See also* Redmond, *supra* note 70, at p 97.

72. *See, eg, Lagunas Nitrate Co v Lagunas Sydicate* [1899] 2 Ch 392 at 435; Redmond, *supra* note 70 at p 97.

73. Tomasic, R, et al, *Corporation Law: Principles, Policy and Process* (1990) at p 336 ("At common law, duties to shareholders may arise not necessarily out of the fiduciary duty owed by the director to the company but out of an independent fiduciary relationship such as agency . . . . ")

74. Redmond, *supra* note 70, at p 97.

75. *See, eg, Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, 428; *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425, 437; *Turquand v Marshall* (1869) LR 4 Ch App 376, 386; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392, 426; Redmond, *supra* note 70, at pp 97-98.

76. Parson, RW, "The Director's Duty of good Faith" (1967) 5 MULR 395, 395; Redmond, *supra* note 70, at p 98.

77. *See supra* notes 8-14, and accompanying text.

78. *See, eg, Re Denham and Co* (1883) 25 Ch D 752; Redmond, *supra* note 70, at p 100.

79. *Re City Equitable* at 429; Redmond, *supra* note 70, at pp 99-100.

80. *See* Trebilcock, MJ, "The Liability of Company Directors for Negligence" (1969) 32 Mod L Rev 499; Redmond, *supra* note 70, at p 100.

81. *See AWA Ltd v Daniels* (1992) 10 ACLC 933; Redmond, *supra* note 70, at p 101.

82. Redmond, *supra* note 70, at p 100, citing Trebilock, *supra* note 80, at p 506; *Dovey v Carey* [1901] AC477, 486,492; *Re Denham & Co* (1883) 25 Ch D 752, 766; *Huckerby v Elliott* [1970] 1 All ER 189, 193, 195; *Land Credit Co* of *Ireland v Lord Formoy* (1870) LR 5 Ch App 763, 770; *Norman v Theodore Goddard* [1992] BCC 14; *Re New Mashongland Exploration Co* [1892] 3 Ch 577.
83. *AWA Ltd v Daniels* (1992) 10 ACLC 933.
84. *AWA Ltd v Daniels* (1992) 10 ACLC 933.
85. Redmond, *supra* note 70, at pp 102-03.
86. *Id* at p 103.
87. *Ibid.*
88. Corporation Law Reform Act 1992 § 232(4).
89. *Id* at §232(1)(a). Moreover, the term officer also includes a receiver, official manager and deputy manager, liquidator and a trustee or other person administering a compromise or arrangement. *Id* at §232 (1)(b-e).
90. Exposure Draft § 232 (4AA); Redmond, *supra* note 70, at p 104.
91. *Australian Institute of Company Directors, Submission to the Attorney - General of the Commonwealth of Australia in the Exposure Draft Law Reform Bill 1992* (May 1992) at pp 19-22; Redmond, *supra* note 70, at p 106; Adams, MA, Australian Corporate Law - *Federalisation Sparks Continuous Reforms* (draft 9/1/93).
92. Senate Standing Committee on Legal and Constitutional Affairs, *Company Director's Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989) at p 335.
93. Companies and Securities Law Review Committee, Report No 10, *Company Directors and Officers,' Indemnification, Relief and Insurance* (1990) at p 75.

94. House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and Rights of Shareholder* (Nov 1991) at p 5430.
95. Redmond, *supra* note 70, at p 111.
96. *Id* at p 112.
97. *Ibid.* The Commonwealth did solicit comments on the issue. *Ibid.*
98. Bradley & Schipani, *supra* note 69.
99. *Id* at p 69.
100. *Ibid.*
101. *Ibid.*
102. *Ibid.*
103. *Ibid.*
104. *Ibid.*
105. *Ibid.*
106. *See supra* notes 3-7 and accompanying text.
107. *See supra* notes 26-32 and accompanying text.
108. *See supra* note 32 and accompanying text.
109. *See supra* notes 72 and accompanying text.
110. *Smith v Van Gorkom* (Del 1985) 488 A2d 858.
111. *See supra* notes 48-49 and accompanying text.
112. Del Code Ann tit 8 § 102(b)(7) (1991 & Supp 1992).
113. *See supra* note 88 and accompanying text.
114. Bradley & Schipani, *supra* note 69, at p 69.
115. *Ibid.*
116. Corporation Law Reform Act 1992 § 232(11).
117. Bradley & Schipani, *supra* note 69 at p 69.

118. *See eg*, Coase, R, "The Nature of the Firm" (1987) 4 Economica 386; Manne, H, "Mergers and the Market for Corporate Control" (1965) 73 J Pol Econ 110; Alchain, A & Demsetz, H, "Production, Information Costs and Economic Organization" (1972) 62 An Econ Rev 777, Jensen, MC & Meckling, W, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J Fin Econ 305; Fama, EF, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288; Fama, EF & Jensen, MC, "Separation of Ownership and Control" (1983) 26 J.L. & Econ. 301.