1984

Corporate Directors Duty of Care: The American Law Institute Project on Corporate Governance

Tamar Frankel

Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance

Tamar Frankel*

Introduction

The American Law Institute's *Principles of Corporate Governance and Structure: Restatement and Recommendations* (ALI Project) has triggered a sharp debate on corporate directors' duty of care.[1] The history of the ALI Project and the events that led to

---

* Professor of Law, Boston University; LL.M. 1964, S.J.D. 1972, Harvard University. I am indebted to Jerry Goldsholle, Esq. for his helpful comments.

1. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 3, 1984) [hereinafter cited as PRINCIPLES or Tentative Draft No. 3]. Section 4.01, Duty of Care of Directors and Officers; the Business Judgment Rule provides:

> (a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation and otherwise consistent with the principles of § 2.01, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.
>
> (b) The duty of care standard set forth in Subsection (a) includes the obligation of a director or officer to make reasonable inquiry in appropriate circumstances.
>
> (c) (1) In performing his duty and functions, a director or officer is entitled to rely on other directors or officers, employees, experts, other persons or committees of the board in accordance with the standards set forth in §§ 4.02-.03. (2) The board may delegate to directors, officers, employees, experts, other persons, or committees of the board the function of identifying matters requiring the attention of the board, and a director, when acting in accordance with the standards set forth in §§ 4.02-.03, is entitled to

its establishment have received different interpretations.[2] All agree, however, that the Project was prompted by a movement to internalize control over the managements of large American corporations through independent, trustworthy boards of directors to which courts will defer; a movement towards increased corporate self-governance.[3] The debate over the ALI Project's statement of

---

> rely on the decisions, judgments, or performance of such persons or committees.
> (d) A director or officer does not violate his duty under this Section with respect to the consequences of a business judgment if he:
> (1) was informed with respect to the subject of the business judgment to the extent he reasonably believed to be appropriate under the circumstances;
> (2) was not interested in the subject of the business judgment and made the judgment in good faith; and
> (3) had a rational basis for believing that the business judgment was in the best interests of the corporation.
> (e) A director or officer who is subect to liability because of the breach of a duty under this Section will be held liable for damage suffered by his corporation only if the breach of a duty was the proximate cause of the damage suffered by the corporation.

(Footnotes omitted). Except for a few definitions that relate solely to Part V, the definitions cited in *Tentative Draft No. 3* are set forth in Part I of *Tentative Draft No. 2. Principles* is a project of the American Law Institute, hereinafter referred to as the ALI.

The problem that the duty of care addresses arises not only in the context of corporate managers and directors; it arises generally when persons agree to serve others ("entrustors"), such as clients of investment advisors, trust beneficiaries, and principals with respect to agents. These entrustors may be unable to monitor the quality of the services for which they bargained, except at very high costs. Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 808-16 (1983). If service givers are self-interested, they may act in a manner that maximizes their own interests, and, although they may have agreed to "give their best," they might serve with less care or with less prudence ultimately defeating the legitimate expectations of the entrustors. Moreover, when legally protected societal interests conflict with those of the executives' and investors' (for example, reducing short-term profits), executives tend to take legal risks to reduce corporate profits in the future rather than expend the costs of avoiding these risks.

2. *See* Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223 (1983) (suggesting that the ALI proposals are largely a description of existing common law doctrine and merely make existing restrictions more explicit); Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187 (1983) (analyzing the history of the ALI Project and concluding that the reexamination and modernization of statutory corporate law is long overdue); Goldstein, *Future Articulation of Corporate Law*, 39 BUS. LAW. 1541 (1984) (addressing the competing ideologies that advocate either more or less control of corporate governance and the various attempts to impose control during recent history including the ALI Project); Kennedy, *The Standard of Responsibility for Directors: Comments on Proposed Section 4.01 of the ALI Statement on Corporate Governance*, 52 GEO. WASH. L. REV. 636-637 (1985) (pointing out the inflexibility of section 4.01 insofar as the articulated duty of care conflicts with the powers of the board and departs from settled case precedent); Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 655 (1985) (criticizing Part IV of *Principles* which is concerned with the duty of care and the business judgment rule; although the draft is supposed to be both descriptive and prescriptive, it fails on both counts); Harold M. Williams, Chairman of the Securities and Exchange Commission, Remarks at the National Conference on Corporate Governance and Accountability in the 1980s (March 27-29 1980) (Williams was a prominent spokesman for the movement).

3. One model for this movement is the Investment Company Act of 1940, 15 U.S.C. § 80a-1-65 and its "deregulation" by the Securities and Exchange Commission through the transfer of powers to, and attendant duties to, the disinterested directors of these companies. *See* 2 T. FRANKEL, THE REGULATION OF MONEY MANAGERS, Chapter VIII C (1980).

the duty of care is important because the results of the debate may provide the acid test of the corporate governance movement and approach.

In a recent article, Bayless Manning performed a commendable and important task in describing the role of the directors of large American corporations.[4] Manning concluded with a proposal that would permit each director to set for himself the standard of care that he would follow, provided that the director sets the standard for himself in "good faith."[5] Another commentator has suggested eliminating the duty altogether.[6] On the other end of the spectrum, critics have suggested that the rule is too lax, and that a stricter standard should apply.[7]

The Project's statement of the directors' duty of care provides a middle ground between these positions. Under the ALI's formulation, courts determine the standard of the duty of care. Yet, judicial standards are influenced by the practices that the majority of corporate boards follow, rather than by the practices of the minorities at the extremes. The leadership of corporate executives, therefore, plays an important role in judicial decisions establishing the standard of care for corporate directors and executives.

This Article discusses a selected list of criticisms, which the proposed ALI duty of care provoked, and explores the results to which they might lead. The Article concludes that the current formulation of the duty of care is useful, when applied judiciously, and that this formulation should not be changed.

A. Criticism: The Duty of Care is Too Vague

One criticism of the duty of care is that the duty is too vague. "There is no common understanding of what directors are supposed to do. Only that they are supposed to do it with care."[8] Indeed, both current law and the ALI Project provide only general guidelines for directors on what degree of care they should exercise in managing their corporations.

To evaluate the criticism of vagueness, one must examine why vague rules are undesirable. Once the reasons for the inadequacy

4. Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality,* 39 BUS. LAW. 1477 (1984) [hereinafter cited as Manning, *The Business Judgment Rule*].
5. *Id.* at 1499.
6. Scott, *Corporation Law and the American Law Institute Corporate Governance Project,* 35 STAN. L. REV. 927, 937 (1983).
7. *See* Brudney, *supra* note 2, at 230-31; Note, *The Propriety of Judicial Deference to Corporate Boards of Directors,* 96 HARV. L. REV. 1894, 1912-13 (1983).
8. Manning, Touring the Horizon with the Business Judgment Rule, at 13 (Draft Oct. 10, 1983 on file available at the George Washington Law Review) [hereinafter cited as Manning, Touring the Horizon].

are found, one can judge whether and to what extent these reasons apply to corporate directors.

Vague rules are presumed to be ineffective, unfair, and highly risky to persons to whom the rules apply. Experience shows that vague rules are ineffective. If a rule applicable to A is not communicated to him, he will not know what is expected of him and might not obey, defeating the purpose of the rule. Furthermore, vague rules are unfair. A is treated unfairly if he is punished, eventhough he could not ascertain what his duties are and was not given a chance to perform them. Vague rules also pose high risk for persons to whom the rules apply, but provide no safe harbor of specificity on which these persons could rely. Naturally, these rules are most risky when enforced by the courts, after the fact.[9] Consequently, if I understand the criticism of vagueness correctly, the general guidelines of the duty of care are ineffective, unfair to directors, and expose them to high legal risks.

An examination of the reasons underlying the objection to vague rules, however, leads to the conclusion that vague rules are appropriate for corporate directors. Directors are vested with very broad powers and discretion precisely because their activities cannot be specified in advance. As Professor Manning described so aptly, the varieties of business strategies and environments under which directors operate are staggering.[10] Specific rules would tie the directors' hands and reduce their usefulness. To specify fully the actions that directors have to take in any conceivable situation would not only result in tremendous costs, but would also require superhuman foresight. Past experience shows that giving specific directives to corporate management is often counterproductive. The approach of "tell me exactly what to do and I will do it" did not result in a desirable or healthy business environment when taken in the areas of environmental law, employees' health hazards, or product safety. Specificity in these cases produced too many detailed rules that made business operation expensive, difficult, and inflexible.

The answer that specificity is unattainable, however, addresses the feasibility of a general rule, but not the argument that a general rule is ineffective, unfair, and highly risky to directors.

I submit that a broad guideline in which the duty of care is framed is appropriate for experienced fiduciaries vested with broad discretion in the exercise of their function. The typical director of a large corporation is a chief executive officer of another large business, educational, or governmental institution.[11] He is

9. *See generally* Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983).

10. Manning, *The Business Judgment Rule*, *supra* note 4, at 1481.

11. *Id.* at 1482. *See generally* Allen, *Continuity and Change Within the Core Corporate Elite*, 19 SOC. Q. 510 (1978) (examining the composition of core corporate elite and its evolution from 1935 to 1970); Koenig & Gogel, *Interlocking Corporate Directorships as a Social Network*, 40 AM. J. ECON. & SOC. 37 (1981) (examining the effect of similar social networks between corporate officers and directors and the effect of

experienced in monitoring those who carry out the institutional mission. Better than anyone else, he knows what effective management involves and what tools should be used to ensure accountability of those under his supervision. As Professor Manning pointed out, directors need not be experts in the particular business of the enterprise; general familiarity with the business is sufficient.[12] Yet, surely directors understand the best and most effective way in which to monitor other corporate executives and ensure that corporate policies are put in place and implemented.

Similarly, directors are quite able to determine the necessary amount of time and attention to devote to current and anticipated issues. Because the standard of care is within directors' expertise, a broad guideline is not unfair as to them. In this respect, directors are similar to other expert fiduciaries, such as attorneys, to whom broad rules prescribing care have been traditionally applied.

As to the risk to which directors are exposed by virtue of the duty of care, there are a number of answers. Such a risk leaves unbound gray areas which may induce directors to err on the bright, rather than on the dark side. More significantly, the risk is bound to produce heightened awareness by the boards. Consequently, directors can, and indeed have, initiated preventive programs in sensitive areas of corporate operations such as the environment.[13] This trend strengthens, and is compatible with, corporate self-governance, reducing the need for judicial and governmental regulation of corporate business.

The directors' risk is reduced by institutional and legal limitations on shareholders' derivative suits, by the business judgment rule, and by indemnification and insurance. Directors' risk is also

---

these networks on corporate control); Useem, *The Social Organization of the American Business Elite and Participation of Corporation Directors in the Governance of American Institutions*, 44 AM. SOC. REV. 553 (1979) (supporting the thesis that American business elite are differentiated along an inner group axis, at least with respect to the selection of business people to assist in governance of other institutions); Whitt, *Is Oil Different? A Comparison of the Social Backgrounds and Organizational Affiliations of Oil and Non-oil Directors*, 29 SOC. PROBS. 142 (1981) (examining the backgrounds between oil industry directors and nonoil industry directors finding no significant variation). Boards may include a few directors who bring to the board special expertise or sensitivity on certain matters, such as minorities and women. These directors may be subject to the duty of care of a different mix: higher in their special areas and lower in respect to other general matters. Yet, the duty-of-care formulation is sufficiently broad and flexible to permit courts to make distinctions and fashion reasonable and fair application of the rule.

12. Manning, *The Business Judgment Rule*, *supra* note 4, at 1482.

13. A. FREEDMAN, INDUSTRY RESPONSE TO HEALTH RISK, A RESEARCH REPORT FROM THE CONFERENCE BOARD 3 (1981). Powerful voices within the corporate community advocate a preventive approach including self-imposed internal controls.

reduced by the influence that board practices have on the judicial standard of the duty of care.[14]

Finally, even though the standard of care is general, subject matter specificity is not the only way to provide directors with a safe harbor; specific process is another. The duty of care, as administered by the courts and restated in the ALI Project, prescribes for the boards a decision-making process of informed deliberation. Rarely do the courts review on the merits directors' decisions that do not involve conflicts of interest. The ALI Project requires that the director be "informed with respect to the subject of the business judgment to the extent that he reasonably believed to be appropriate under the circumstances."[15] This process is criticized, it seems, as too specific. The criticism is puzzling in light of objections to the substantive part of the rule as too general. If the concern of the critics is that directors are exposed to legal risk, why not support process as a method of reducing the risk? I therefore submit that the generality of the standard of the duty of care is necessary and appropriate.

B. Criticism of the Process

As stated above, the specificity of the required process under the duty of care has also raised criticism.[16] Any reasoned, deliberate decision can be subject to second guessing by hindsight. Yet, this problem is exacerbated when there is no showing of informed deliberation; courts have continually stated that board decisions must be evaluated in light of the circumstances at the time of the decision, not in light of later events.[17]

The criticism of the required process is based, among other things, on the "reality of corporate boards." Critics emphasize that directors function under severe time constraints. Outside directors commit only a fraction of their time to the business of the corporations on whose boards they serve.[18] Therefore, they may not be able to study innumerable documents, nor be informed about the many business details of huge enterprises.[19] Furthermore, even though the boards have the legal authority to deter-

14. The ALI Project formulates the standard of care as that which "an ordinary prudent person would reasonably be expected to exercise in a *like position* and under *similar circumstances*" (emphasis added). Consequently the standard is influenced by acceptable practices of boards of comparable corporations.

15. Tentative Draft No. 3, *supra* note 1, § 4.01(d)(1).

16. Manning, Touring the Horizon, *supra* note 8, at 20.

17. *See, e.g.,* Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940) ("[I]n order to determine whether transactions approved by a director subject him to liability for negligence, we must look to the facts as they exist at the time of their occurrence not aided or enlightened by those which subsequently took place.").

18. Manning, *The Business Judgment Rule, supra* note 4, at 1481.

19. Directors use not only internal reports but also external reports including those of regulatory agencies, as directors should. Occasionally they are required by law to read agency reports. New York insurance law has, until recently, required that the reports of the staff of the Superintendent of Insurance be *read aloud* at the board meetings. *See* N.Y. INS. LAW § 31 (McKinney 1966). This extreme position has been deleted and directors may now read the reports, instead of being read to, outside the board meetings. N.Y. Ins. Law § 31 (McKinney 1984). Any responsible director would agree that the board members should indeed read these reports.

mine their own agendas and specify which issues should be brought before them periodically and which issues should be brought before them as events occur, it is stated that in fact boards do not exercise this authority.[20]

Implicit in these statements are two unexpressed conclusions. The first is that the duty of care remain flexible, and that the courts should take into account the "reality of the boards." The second unexpressed conclusion is that it is impossible for outside directors to effectively monitor executives and to maintain the risks of the corporate business at an acceptable level.

The answer to the first conclusion is that courts do take into consideration that directors function only part-time; courts do adjust the standard of care accordingly.[21] If the second conclusion lurks behind the first, then the answer is that no self-respecting and responsible director would go below a minimal standard of care, neither would he expect his colleagues or the courts to set a standard below the minimum, nor could he condone a "figurehead" directorship.[22]

20. Professor Manning argued that directors, with a few important exceptions, do not establish the board's agenda. *See* Manning, *The Business Judgment Rule, supra* note 4, at 1484-85. The statement, however, may be too broad. First, the identity of those who determine agendas may depend on the power structure within each corporation. An outside director, who holds large shareholding or corporate debt, may wield sufficient clout to introduce into the agenda items of interest to him. Second, because of corporate law prohibitions, the agendas include matters involving executives' conflicts of interest and executive compensation. Third, specific laws require that directors decide certain matters. *See, e.g.*, Investment Company Act, §§ 15(a), (c), 17(j), 15 U.S.C. § 80a-15(a), (c), 17(j) (1982). Bank directors, too, are required to decide certain operational aspects of the bank. Therefore, if the power structure within the corporation does not result in a sufficiently substantive and informative agenda, the law can and does correct the deficiency. The issue is not whether boards currently use legal power to establish their agendas to give meaningful controls, but whether they should. In *The Business Judgment Rule*, Manning would limit the extent of the board's legally *required* exercise of power to establish its agenda to only two areas which directors cannot ignore. The rationale that corporate power structure does not permit directors to establish their agendas conflicts with these exceptions. If the "reality" of the board precludes members from raising questions within the exceptions *The Business Judgment Rule* carves out (*e.g.*, matters dealing with an internal information system), then the Manning rationale would lead to relieving directors of liability even as to the excepted matter.

21. *See, e.g.*, Graham v. Allis Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963). "By reason of the extent and complexity of the company's operations, it is not practicable for the Board to consider in detail specific problems of the various divisions." *Id.* at 82, 188 A.2d at 128. "The duties of the Allis Chalmers directors were fixed by the nature of the enterprise. . . . The very magnitude of the enterpise required them to confine their control to the broad policy decisions." *Id.* at 85, 188 A.2d at 130.

22. The "figurehead" director is gone from the board scene of large American corporations today. The public has come to rely on board members who attend to the business of the corporation on a level acceptable in the business community. The consequences of this development are discussed *infra* note 23 and accompanying text.

The issue of time constraint is not unique to directors. It appears in the context of professional fiduciaries. Individual attorneys, particularly successful ones, make commitments to many clients, to civic causes, to public service. There comes a point, however, at which they must decline additional commitments in order to honor existing ones.

Specific process is necessary to enable the courts to review the boards' decisions. If the merits of the decisions are left to the directors' business judgment, free of judicial review, then the process by which these decisions are reached would ensure that the directors do exercise their business judgment. This is, in fact, what the duty of informed deliberation means.

Being experienced executives, directors know that monitoring techniques include requirements for at least some written explanations, especially when other measures for testing the quality of service, such as results, are not available. Directors' performance cannot be judged by short-term corporate profits, because the financial condition of the corporation may depend on circumstances beyond their control. Directors' performance can be evaluated mainly by their decision-making process.

Specific process is therefore necessary because it makes directors accountable. It provides them with at least a partial safe harbor and enables them to create a paper record in support of their business judgment. Furthermore, the majority of directors themselves would not subscribe to an empty standard in performing their duties. I conclude that the argument that the required process under the duty of care is onerous and unrealistic is not persuasive.

C. *Criticism: The Duty of Care Is Costly*

Critics of the substantive and procedural aspects of the duty of care argue that the duty is costly. Clearly, the more time and attention required of persons whose time and attention are valuable, the higher their remuneration should become. In addition, the requirement of process may lead to a greater involvement of counsel and other expert advisers and attendant fees and, finally, to more paperwork. The duty of care may also result in litigation and attendant costs. Litigation cost is a special problem involving broader issues than the duty of care. More importantly, costs should be evaluated in light of the benefits that these costs are likely to produce. Among these benefits are mainly the following four. First, the directors may hold the executives' feet to the fire, so to speak. A subtle pressure, but nonetheless pressure, exists when the board is attentive and informed. Second, the costs involved in outside directors' compensation are miniscule as compared to the value of their services.[23] Third, attentive boards

23. Assuming that directors receive approximately $24,000 a year for spending 120 hours at board meetings, the corporation receives top talent for $200 an hour, a price available nowhere. Even if the executives sitting on the boards receive approximately $125,000 from the organizations which they manage for 2500 hours of work, the rate of

make substantial contributions as a testing ground for corporate strategies. They can thus assist in making the corporation a well-run institution. Fourth, an attentive board reduces the probability of sudden, unanticipated mishaps or difficulties. I submit that these benefits outweigh the costs.

D. *Criticism: The Effect of the Duty of Care is to Chill Entrepreneurial Zeal*

Critics charge that the duty of care may deter directors and their corporations from taking business risks, thereby chilling innovative and creative activities, which the law ought to encourage.[24] I agree with the public policy of encouraging innovative business activities. In fact, doing nothing is sometimes a riskier policy than trying something new. The duty of care, however, helps ensure that directors are attentive to prevent the kind of risk that does not benefit the corporation.

In some cases the incentive system and balance of risk between the executives and the shareholders may result in executives' tendency to take too much, not too little, risk in operating the company. Laws that prohibit corporations from free-riding at the expense of society, such as polluting the environment, pose future financial risks to the corporation that executives, pressed for immediate profits, may overlook to avoid immediate costs. Therefore, the rule may dampen the kind of risks that executives should not take.

Moreover, the duty of care is aimed at ensuring that corporate directors will be aware of what the risks are. The law requires that they set a rational level of the risk, not insure against it. By and large, that level is left to the business judgment of the directors. No responsible director would simply ignore warning signs. Legal liability attaches only to behavior that is unacceptable to such a responsible director.

The duty of care is aimed at risks that are unacceptable in the business community. A bank board that approves additional loans to a failing customer, in the hope that the customer's financial condition will improve, when all other creditor banks are demanding the repayment of their loans, might be violating its duty of care. Here the risk is taken against great odds, in disregard of the judgment of other informed lenders. The risk does not involve creativity or innovation; it is as old as banking itself. If these bank

---

compensation per hour for these executives is not less than $1000 an hour. If we add fringe benefits for these executives, their compensation level might double. Thus, the corporation on whose board these directors serve receives, in exchange for $200, quality service for which the market pays five to ten times as much.

24. Scott, *supra* note 6, at 946.

directors approve, without informed deliberation, the executives' decision to continue lending, the directors might be violating their duty of care. Directors' faith in the corporate executive does not mean blind faith.

Similarly, when the corporation takes risks by marketing a new product, which is later found to endanger consumers' safety and results in a large unanticipated court judgment against the corporation, the board might not be responsible for the corporation's losses. However, if after the judgment is paid, the board fails to inquire into the reasons for the mishap and into ways to prevent its future occurrence, the board might have breached its duty of care.

Finally, there is no evidence that corporations producing innovative products have terminated the business to protect their directors from liabilities.[25] There is evidence that they tend to establish preventive measures to avoid losses and continue to monitor sensitive areas as they get notice of them. Thus, rather than chilling innovation, the effect of the duty of care is to chill unacceptable behavior.

E. Criticism: The Duty of Care is Inappropriate Because the Courts are Unsuitable to Oversee Corporate Boards

The legal duty of care, it is argued, is inappropriate because courts are inappropriate supervisors of large institutions. Courts are institutionally designed to deal in discrete conflicts among few individuals, not in conflicts affecting intra-institutional relations.[26] This argument is not easily dismissed. Judicial interference in internal corporate activities is indeed problematic. Courts have developed corporate law by analogies to relations among individuals. The rules may be too inflexible or too general to suit all corporations. Yet, for this very reason courts are generally averse to such interference. When corporate governance and structure were changed by judicial decrees, these decrees were usually based on consent orders.[27]

Furthermore, the tension between the need for flexibility in the structure of large corporations and legal rules, which introduce inflexibility or too much generality, is not unique to corporate law. This tension exists when courts review decisions involving labor management relations or decisions of administrative agencies. In all these cases, the decision makers are subject to judicial review, constraints, and accountability. In all these cases, the courts are

25. These companies may, however, wisely tend to diversify the business because of business, not legal, risks.

26. Frankel, *supra* note 1, at 804-08.

27. Note, *The SEC and Court-Appointed Directors: Time to Tailor the Directors to Fit the Suit*, 60 WASH. U.L.Q. 507 (1982) (tracing the development of court-appointed directors in SEC injunctive actions and concluding that the SEC should modify its use of consent-decree director appointments as a means for reform. The SEC should instead return the remedy to its legal foundations: redressing of wrongdoing).

sensitive to the effects of their ad hoc judgments on institutional, internal affairs.

Critics argue that courts are unsuitable to oversee corporate boards because courts lack business expertise. The argument flies in the face of judicial reality. For decades, judges have used macroeconomic analysis in the antitrust area and have made business decisions in the bankruptcy, probate, and trust fields. It is true that these areas of the law are distinguished from corporate law. They do not involve the courts in entrepreneurial businesses to the same extent carried out by corporations. But this distinction is relevant to the adverse impact of judicial interference in a changing business environment. It does not bear on the evaluation of judicial business expertise. Besides, if courts lack business expertise, they are also incapable of reviewing boards' decisions that involve conflicts of interest. And yet, who would suggest such a conclusion? Finally, courts can be educated by expert testimony, including that of directors and executives. That courts defer to disinterested directors' decisions does not prove that courts lack the expertise to decide business issues. It proves only that courts choose when it is appropriate to defer to trustworthy corporate internal control groups such as the boards.

In sum, limitations of judicial review over institutions are not unique to corporate law. The limitations are inherent in the judicial process and the nature of the institution which the courts supervise. The problem is ameliorated by judicial sensitivity to it.

F. Criticism: The Duty of Care is Dead

Few court decisions are based on the duty of care. Consequently, one critic concluded that the duty should be eliminated.[28] Even if this evaluation of the duty were correct, the vitality and use of the duty is irrelevant to the issue of whether the duty should remain on the books. If the duty is a dead letter, one might ask what is all the excitement about? There are many dormant rules on the books; yet, these rules do not raise the kind of furor that the duty of care has raised recently. If the duty of care is preached but not practiced, then the directors' legal risk is low; why not leave the rule on the books? On the other hand, it has been argued that it is wrong to leave the duty of care dormant; that it should be revitalized and enforced strictly.[29]

28. Scott, *supra* note 6, at 935-36.

29. *See, e.g.*, Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983) (suggesting, as a solution for the alleged dormant status of the duty of care, that the rule be strictly enforced).

One critic noted the revival of the duty in recent cases against failed bank directors[30] and drew from this revival the conclusion that the substance and procedure of the duty should be changed. All these conclusions are in the eyes of the beholders.

The assumption that the duty of care is dead is not borne out by its history. In fact, a long-term view of the duty of care seems to show that it is dormant. Courts do not base their decisions on the duty of care as often as they do on the duty of loyalty, but invoke the duty of care in special cases when directors have no conflicts of interest. In any event, the arguments regarding the status of the duty have little bearing on the main issue. The fact that the duty is invoked in unique circumstances and not regularly is irrelevant to determine whether the imposition of the duty is justified, and if it is, what standards it should impose.

G. *Two Proposals to Which the Criticism of the Duty of Care Leads*

Two specific proposals are made by critics of the ALI Project with respect to the duty of care. The first is to eliminate the duty altogether.[31] The second is to make it self-defining, that is, to follow the standard that each director sets for himself in good faith.[32] Directors should determine what their function should be, how much time they should commit to corporate business, how much information they should obtain, and to what extent they should supervise corporate executives.

These proposals, however, may not necessarily free directors from legal responsibility. The proposals may lead to more, not less litigation.

Currently, disinterested directors have the primary authority over the situations in which executives act with conflicts of interest. In these cases, disinterested outside directors play a decisive role in "representing" the corporation, because the courts defer to a great extent to these directors' decisions. Far from being unimportant, the duty of care is crucial to the current status of judicial intervention in corporate internal affairs. If outside directors are free of the duty of care in the manner in which they function, then the courts should not defer to their approval of executives' self-dealing transactions or executives' compensation. I believe that the results of erasing the duty of care would be to increase the extent of judicial review over executives' self-dealings and compensation. The proposed self-limiting duty may also prove to be far more onerous to directors than the ALI's formulation of the duty. If the burden of proving good faith is placed on them, directors may be required to document it in advance, when the decision

30. *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982) (court found high potential for liability pointing out that, under the facts, the duty of care may have been violated), *cert. denied*, 460 U.S. 1051 (1983). *See generally* Deal, *Liability of Bank Directors*, 39 BUS. LAW. 1033 (1984).

31. Scott, *supra* note 6, at 935-36.

32. Manning, *The Business Judgment Rule*, *supra* note 4, at 1499.

is made — a costly and perhaps impossible task. The issue of the burden of proof may embroil the directors in litigation for years. Since those who advocate the elimination of the duty of care prefer less, not more, judicial interference, both proposals may well lead to precisely the opposite of what they wish to achieve.

The proposals might not be followed by the courts. If the law eliminates the duty of care altogether, or if the duty becomes self-defined and self-enforcing, that law may well become a dead letter. Some courts may, in a particular case, place their trust in a particular board and defer to its decision. But it is naive to think that, if the courts suspect harm to society or to the enterprise, they will refrain from introducing their own standards and processes for the boards to follow. This is particularly true with respect to the proposal to leave the standard of the duty of care to each director acting in good faith. History teaches us that this society does not tolerate power without responsibility. Directors know this principle better than anyone else. That is why they are successful executives within their own organizations.

The ALI's proposal limits the directors' money liability to $100,000.[33] It has been argued that the courts might tend to circumvent this limit.[34] This result is possible, but improbable, in light of judicial deference to specific numerical limitations established by law. Clear drafting will minimize the directors' risk of higher liability. On the other hand, when it comes to powers and duties of fiduciaries, courts have traditionally asserted their authority (in spite of contractual directives) to fashion both powers and duties for fiduciaries and have maintained as a public policy the basic model. Those who manage and control other peoples' money must be judicially accountable.[35] It is, therefore, unlikely that the courts will relinquish their authority over directors' fiduciary duties.[36]

33. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.06 (Tent. Draft No. 1, 1982).

34. Manning, *The Business Judgment Rule*, *supra* note 4, at 1498.

35. Frankel, *supra* note 1, at 821-24.

36. To eliminate the duty of care, without more, would create a dangerous precedent. Even though currently no one suggests that the duty of loyalty be eliminated, a theoretical basis may be developed to eliminate that duty as well. A recent study, for example, purports to show that the compensation of directors of banks subject to take-over threats is lower than the compensation of directors of banks not subject to such a threat, by virtue of protective state legislation. *See* James, *An Analysis of the Effect of State Acquisition Laws on Managerial Efficiency: the Case of the Bank Holding Company Acquisitions*, 27 J. L. & ECON. 211, 214, 222-26 (1984). The logical conclusion from such a study is that compensation of bank executives, and presumably those of other corporations as well, ought to be left to market competition and that the markets rather than the courts would set these compensations at the right level. Assuming, as I do, that markets are not entirely efficient, and that judicial review of

The critics' proposals provide a basis for the argument that the movement for corporate self-governance has failed. The arguments that directors are unable to undertake serious involvement in the corporation on whose boards they serve, and are consequently unwilling to be legally responsible for their decisions, are an invitation to counter-proposals that directors' powers should decrease, deference to their decisions should cease, and that they should function as advisory boards. A further inquiry will then have to be made as to what should substitute for the boards.

I am not certain that the proposals to relieve boards of directors of large American corporations from legal responsibility for care represent the wishes of the outside directors of these corporations. Excess in one direction leads to excess in the opposite direction. Power without responsibility will inevitably lead to a backlash resulting in stricter liabilities far more burdensome than the current duty of care proposed by the ALI. I have serious doubts whether extreme positions, such as the elimination of directors' duty to act with care, are serving directors and their corporations well. Weighing the possible alternatives, outside directors may find that they prefer the middle road taken by the ALI Project after all.

corporate executives is necessary, the elimination of the duty of care is the first step to the elimination of judicial review of corporate management decisions in general.