# The Standard of Care of Directors

**The Role of Directors**

The role of the directors is part of a large discussion since the past decades depending on different factors which are related to the corporate governance. But why, one can ask, should it be important to analyse the directors role in relationship to his company or other parties? The answer might be that there is not a standard but different standards of care depending on the roles the directors are exercising. In a functional view, the role of directors is possibly the key to the different duties and at least to the various degrees of care.

Which functions are to be assigning to directors?

First one have to consider the company`s sight of view. An important model provided in the economic literature is that of the "principal-agent" relationship. The company, as principals, appoints directors as its agents. They are expected to act in the interests of the company. But giving directors the positions of agents does not mean that they cannot have their own interests and that this interests are always conform with the company. As agents they are able to follow their own interests which will often be different to those of the company, so one can say that the directors role is settled between the company`s and his own personal interests.

This item stands in the direct opposite to the German perspective, which see the director as an "organ"; that means the director is a part of the company, he or she "is" the company. The consequence is to require a higher level of care. § 93 (1) German Aktiengesetz deals with an objective standard. It says: " The members of the board of directors have to exercise a standard of care and diligence of a proper and conscientious managing director." To explain the role of directors in Germany it seems useful to compare the different corporate governances underlying to English, Australian and American company law. Especially for German public limited companies (Aktiengesellschaften) the two tires system takes place, there is not only the board of directors but also the supervisory board (Aufsichtsrat), which appoints the members of the board. Whilst the countries of the common law hemisphere give priority to the one tire model, they contribute the board of directors a greater credit of confidence. There is the idea of a trustee like position of board members which seems to be a contradiction to the commencing thesis of the principal-agent role. But it might lead to a solution to have a look at the different functions directors exercise. In deed there are different positions like executive and non executive directors, thus who sits in specialised committees, for example dealing with audit, and so on. Much of the current corporate governance debate is attempting to substantiate different roles for a concrete position. So the particular role of non executive directors could be essentially as monitors of their executive colleges. Other functions could be such as the role of inquiry, to employ reasonable decision-making processes and, last but not least, reasonable

decisions.
In this context some authors provide, as a possible model, a remuneration of functions for one class of directors. The idea behind this is that the presence of professional boards, meaning those that are active and independent of management, is associated with higher returns to investors. To verify the dependence between the role, different functions of directors and the various liabilities the Smith v. van Gorkom Case should be discussed.
Mr. Van Gorkom, the Chairman of the Board and Chief Executive Officer of a profitable company tried to raise the price of the stock and so he contacted Mr. Pritzker, an well known investor to be interested in purchasing companies. Van Gorkom met him without consulting the board of directors in advance. The board of directors consisted of 5 outside directors, who were unaffiliated with the company and further 5 company employed members. Mr. Pritzker made an offer to buy the company for a price, which was almost 40% higher than the current market price and also higher than the price of the shares in the previous 5 years. Without having any prior notice of this offer the board voted to accept the deal. They received limited advice from the financial officers in the company but no external opinion from anyone else as for example investment bankers to recognise the right price. Smith, one of the shareholders, sued the directors and at least the case was settled with an additional payment to the shareholders of over $ 23 million, and this although approximately 70 % of the shareholders approved that merger and only 7.25 % voted against it. The judges of the Delaware Supreme Court held a controversial decision with 3 of the 7 dissenting, which shows the difficulties of a case like that. To understand the underlying reasoning for this decision the key is not to identify the (perhaps bad) result, not the decision of the directors board itself, but the way of the decision finding process (it is also the issue of the business judgment rule). The role of the director in this special case is to be seen as someone who must be able to overview the consequences of his or her decisions. A proper decision finding process depends on internal and external facts and, of course, subjective and objective conditions.
How can it happen that all directors have been treated in the same way although the position, function and at least the role is not parent ? Why didn`t the trial court distinguish between the chairman, the employed and the outside directors? Arguing with the duty of care is a question of functionality . For example, the lack of information concerning to a decision finding process can only lead to a breach of a duty if there is an appropriate position (or lets say credit) given to that person which enables him or her to act so.
This thesis is to be verifying by internet and e-commerce companies. How could it be that shareholders of such a company appoints a director who do not know all about that business? If it is true that the directors has the duty to be informed than the role of the director is to figure out as a person which either acts on behalf of the company, the behalf of the shareholders or perhaps third parties. The “new economy” effects this

shareholders or perhaps third parties. The "new economy" effects this rules in a way that points out the inner dependency. E-commerce and Internet companies put a great deal to effort into recruiting and retaining board members who are well known in their branches and who have extensive business experience and contacts. Retaining an able individual for such a position can help a new venture establish credibility and immediately raise awareness about the company.

Another aspect of directors role is the limiting exposure. In light of the substantial liability that can be imposed on directors there is an extended demand for limiting the financial exposure that directors personally face. For example, Delaware, Section 102 (b) (7) of the General Corporation Law permits a Delaware corporation to include in its certificate of incorporation a provision limiting the personal liability of a director to the corporation or its stockholders for violations of the duty of care. This Directors and Officers Liability Insurance (D&O Insurance) helps protect the directors and officers of the Company against claims alleging:

- employee discrimination or unfair employment practices
- wrongful termination
- disposal of corporate assets, without regard to the firm`s ability to pay for or secure company`s debts
- wrongful denial or termination of credit to any customer or client
- violation of the anti-trust laws or unfair methods of competition
- violation of a loan covenant
- exorbitant dividend payments or profit sharing contributions which were made by the company
- improper loans made to directors of officers.

The functionality of this D&O Insurance can be described by considering two stages:

First, to have a look at the different potential claimants. Having a focus on non profit organisations the potential claimants are:

- the organisation: claims against former D& O`s or by a member asserting a claim on behalf of the organisation
- directors: claims against fellow directors
- members: claims against D&O`s to protect the members` interest in seeing the purpose of the organisation fulfilled
- beneficiaries: claims by the recipients of the organisation`s services
- donors: claims by those who donate money to the organisation
- outsiders: claims by third parties who transact business with the organisation
- attorney general: claims to uphold the law and to represent the interests of the public in assuring proper management.

Second, there are sections which are not covered by the D&O Insurance and will not protect a director in certain circumstances, especially when the director does not act in good faith, knowingly violates the law or derives an improper personal benefit.

As a provisional result we have to hold on, that the role of directors determinates the starting point, from which the duties and at least the

standard of care can be developed.
The role of directors in relationship to the company depends on (to account only some important aspects, which cannot be complete):
- the legal form and structure of the company, for example partnership, private or public corporation
- the legal act
- the memorandum of association
- the articles of association
- the size of the company
- the purpose of the company, weather it is a profit or non-profit company
- the branch, the inquires the directors are much higher in the internet and e-commerce business than in some traditional ones
- the concrete position of directors, like executive, non executive, external or employed
- the personal facts, such as experienced or just newcomer, the directors` pre-history.

The role of directors is also to determine in relationship to the shareholders, creditors, employees, the general meeting and third parties. Most of the aspects that were discussed concerning to the company will comply with the general relationship to the other internal or external parties which were listed above. Nevertheless there will be special interests and functions given to the board of directors either in general or according to special situations.

**The Duty of Care**

To understand the relationship between the role and the duty of directors two quotations of judgements can give a first impression: In AWA Ltd v. Daniels Rogers CJ held (at page 864)
" …A director is obliged to obtain at least a general understanding of the business of the company and the effect that a changing economy have on that business. Directors should bring an informed and independent judgement to bear an the various matters that come to the Board for decision… of necessity, as the complexities of commercial life have intensified
community has to come to expect more than formerly from directors whose task is to govern the affairs of companies to which large sums of money are committed by way of equity capital or loan. The affairs of a company with a large annual turnover, large stake in assets and liabilities, the use of very substancial resources and hundreds, if not thousands of employees demands an appreciable degree of diligent application by its directors if they are to attempt to do their duty. To some extent this has been recognised by the fact that the compensation paid to non-executive directors has changed from a modest honorarium to a sum which bears a measurable relationship to the work expected of a director…."

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And in Daniels (formerly practising as Deloitte Haskins&Sells) v. Anderson the court states:
"…A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director. The duty is a common law duty to take reasonable care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred upon them for private purpose or for any purpose foreign to the power and paced … at the apex of the structure of direction and management. The duty includes that of acting collectively to manage the company. Breach of duty will found an action for negligence at the suit of the company…"

Both judgements pointed out the duty of care as a measure and standard of liability of the company and their directors and that the duties the directors have to exercise are not to be seen as fixed or even as static but in the ongoing relations to the company or other related persons. So one can say, the duties of directors vary between different fixing points which are set from the company, the shareholders, creditors, other third parties and last but not least by the specific director himself.

Australia is one of the few countries which has defined the duty of care as a statutory obligation in section 180 ff of the Corporations Law (CL) of 1999. According to this provisions section 180 (1) states:
"A director or officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
(a) were a director or officer of a corporation in the coporation`s circumstances; and
(b) occupied the office held by, and had the same responsibilities within the corporation as the director or officer."
In section 180 (2) the Corporation Law defines the business judgment rule (of Australia) as follows:
" A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their aquivalent duties at common law and in equity, in respect of the judgment if they:
(a) make the judgment in good faith for a propper purpose; and
(b) do not have a material personal interest in the subject matter of the judgment: and
(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate: and
(d) rationally believe that the judgment is in the best interests of the corporation.

The director`s or officer`s belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold."

Section 180 (3) gives a definition of "business judgment".
Complying to this subsection "Business judgment means any decisions to take or not take action in respect of a matter relevant to the business of the corporation". The idea of the business judgment rules are that the common law and statutories can set a standard but is not to be seen as a fixed measure for the judges. The courts will defer to the directors` decision which will not be second guessed by the courts. Otherwise the directors wouldn`t be able to do what they are appointed for, to act as agents in the best interest of the company. That is also the reason for limiting the judgment on the decision finding process but not the result of the judgment. Although this main sentences are sometimes critizised, specially that the result of decisions shouldn`t be under the courts view ex ante, there is not a serious alternative to the above explanation, cause otherwise nobody would take the risk of the demise of the duty of care.
In the United States of America Delaware law is the de facto natural corporation law of the U.S.. Even though every state has its own law of corporations a majority of the largest firms are incorporated in Delaware and many state judges recognize the experience that the Delaware judiciary have.
As statutories the Revised Model Business Corporation Act § 8.30 states that directors must discharge their duties in good faith and with the care an ordinarily prudent person in such a position would exercise in similar circumstances and in a way he or she believes to be in the best interests of the corporation.

Under German law § 93 Aktiengesetz gives special instructions of what the members of the board of directors have to or not to do (feasance and malfeasance). § 93 (1) s.2 AktG states that secrets of facts and such of the corporation which members of the board of directors received by exercising their powers have to be disclaimed. Subsection (3) of this provision deals with tort negligence and counts a list of duties by saying:
"(3) The members of the board of directors are negligent of tort by breaching this law in case of
1. giving back the shares to the shareholders,
2. paying back interest rates or other profits to shareholders,
3. drawing own shares of the company or of another company, purchasing, receiving or
withdrawing to pledge,
4. issuing shares before receiving the amount of money,
5.dividing assets of the company,
6. making payments after insolvency or debt overload of the company,
7. granting remuneration to members of the supervisory board,
8. granting loans,
9. issuing preference shares in case of capital increase out of company

9. issuing preference shares in case of capital increase out of company resources or before paying the full equivalent."
This duties mentioned above are special provisions to the general standard of paragraph (1) of § 93 Aktiengesetz dealing with the duty of care of a proper and conscientious director. As for German understanding these duties grant double functions, first to set a standard of negligence, second to provide (objective) instructions to directors.
All of the duties are to be reduced to some important moral obligations which were be pointed out by Eisenberg when he elaborates the moral obligation as an aggregate comprised of four relatively distinct duties, each of which requires separate analysis. These are:
" (1) The duty of directors to reasonably monitor or oversee the conduct of the corporation`s business, and as a corollary, to take reasonable steps to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques.
(2) The duty of inquiry that is, the duty to follow up reasonably an information that has been acquired and should raise cause for concern.
(3) The duty to employ a reasonable decisionmaking process.
(4) The duty to make reasonable decisions."

**Different Ideas about the Standard of Care**
Thinking about the standard of care under consideration of what is mentioned above, namely as an instrument of degree measuring, implicates two perspectives, first that of a subjective standard, second an objective measure.
**Subjective Standard**
To understand the idea of an subjective standard of care, it is helpful to look for the English legal history and a distinction that grew up as a result of that history between a realm of legal and of equitable rights and duties. In jurisdiction built upon English law the director is an agent exercising a fiduciary position in relationship to the company as a principal. The essence of this position is that they can constrain the execution of otherwise lawful legal right and that a court of equity will specifically enforce such constraint. Observing a trustee like situation to directors inquires to focus the interests of the company and the expectations the company will have. In anticipation of what the director is dealing with the subjective standard seems to be the "natural" standard. In the common law world there have been some remarkable cases such as Re City Equitable Fire which can give an idea of the subjective standard when the court derived three general propositions:
"(1) a director need exhibit only the degree of skill expected of a person of his knowledge and experience.
(2) a director need not give continous attention to the company`s affairs, but should discharge his duties at periodical meetings.
(3) a director may delegate his functions to another official within the company in absence of any grounds for doubting that official`s honesty."

The director, from that point of view, is acting with a large space of

discretion of what he is thinking is the best for the company, perhaps also for the shareholders, the creditors, the employees or third persons. The basic idea is that of interests, which means that every different group of related persons to the company we deal with, has its specific interests. But than the next stage is to realise the interest as the measure for the degree of care. Subjective in this context is to be seen as an reflex of what is given to the director, or lets say, what expectations the company has been provided. From that point of view the subjective standard is the "right" standard. For example, if the company deals with e-commerce they will look for a director who is able to exercise all the special duties the company can expect in this branch. So the subjective standard is not fixed but to recognise from the perspective of the director. The problem is to translate this loose concept of a subjective approach into some more concrete legal test. This perhaps "fuzzy" measure will turn into an acceptable standard when the role of the account of directors is specific, so that there will be less opportunity for directors to argue that they failed to realise what the job demanded of them in any particular situation.

**Objective Standard**

An objective standard in the meaning of invariant or perhaps fixed might give more sureness to the company, shareholders, creditors or others at first sight, but at least will be a disadvantage for all parties relating to the corporation. Which director will accept the ongoing risks? Even if the remuneration would be on a higher level, there would be a lack of incentive for such a high standard of liability. It is one familiar complaint against such a standard that it render directors excessively cautious in their stewardship of the company. Directors will avoid taking risky decisions which are essential to a successful business. Referring to the business judgment rules, as we discussed them in the context of the duty of care, it is to consider that the judges have only limited business experience and that the court is not able to (second) guess director`s decisions.

On the other hand not only under German law, for example § 93 (1) Aktiengesetz, but also in the anglo-american experience the necessity of an objective standard is acknowledged. But there is also no denying "that in a world without agent opportunism at least, a legal command that an agent exercise care or attention proportional to the magnitude of the decision`s impact upon the principal would tend systematically to produce efficiency enhancements, when compared to alternative rules."

But at least the question is what objective really means? If one have a look at the German definition in § 93 (1) Aktiengesetz objective is defined "as diligence of a proper and conscientious director" and in this context there is not a big difference to, for example, the Australian provisions in section 180 (1) of the Corporations Law dealing with "the degree of care and diligence that a reasonable person would exercise." Is this really an invariant standard of care? The solution could be to understand objective as a minimum standard but
under consideration and by reflecting the special role the director is imposed to deal with.

impossed to deal with.

**Conclusion**

When we than go back to Chapter 1) reflecting the role of directors as special duties there are areas with subjective and such with objective standards to be set. The right standard depends on the concrete duty. If, for example, the company declares the “welfare maximising” as a favourite duty only a subjective standard will lead to the best results; but to impede insolvency only an objective standard is able to ensure the company`s interests. This functional sight of standard of care will lead to solutions which consider not only the interests of the company but also that of the directors.

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