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## OBSERVATION

# CORPORATE DIRECTORS' ACCOUNTABILITY: THE RACE TO THE BOTTOM— THE SECOND LAP

THOMAS LEE HAZEN†

Corporate directors are generally said to owe two types of obligations to their corporations. First, they are held to a duty of loyalty.<sup>1</sup> The duty of loyalty requires that in making decisions, directors must place the corporation's interests above their own. A byproduct of this obligation has been the rules that limit the ability of interested directors to act upon matters affecting their self-interest.<sup>2</sup> The second director obligation, which has been formulated in various ways, is the duty of care.<sup>3</sup> Simply put, the duty of care requires that directors perform their duties within the standards of reasonable conduct. A corollary of the duty of care is the business judgment rule, which provides that directors who have no interest in the transaction are presumed to have exercised judgment.<sup>4</sup> Since the inception of American corporate law, there have been only a handful of reported cases holding corporate directors accountable for a breach of their duty of care in situations not raising questions of divided loyalty.<sup>5</sup>

There has been a variety of legislative responses to the fear that corpora-

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1. See generally Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966) (discussing potential conflict between director's duty to company and self-interest).

2. E.g., REV. MODEL BUSINESS CORP. ACT § 8.31 (1985).

3. See, e.g., GA. CODE ANN. § 14-2-152.1 (1987) ("care an ordinary prudent person in a like position would exercise under similar circumstances"); N.C. GEN. STAT. § 55-35 (1982) ("care which ordinarily prudent men would exercise under similar circumstances in like positions").

4. The business judgment rule has existed for over 150 years. See Percy v. Millaudon, 8 Mart. 68 (La. 1829); see generally D. BLOCK, THE BUSINESS JUDGMENT RULE (1987) (discussing in part the application of the business judgment rule to corporate takeovers, shareholder derivative suits, and indemnification and insurance of corporate officials); H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 242 (3d ed. 1983) (stating general rule and citing cases from various jurisdictions).

The failure to make an adequate investigation has been held to preclude the applicability of the business judgment rule. Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985).

5. Bates v. Dresser, 251 U.S. 524, 530 (1920); Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985); Francis v. United Jersey Bank, 87 N.J. 15, 45, 432 A.2d 814, 829 (1981); Hun v. Cary, 82 N.Y. 65, 79 (1880); O'Connor v. First Nat'l Investors' Corp., 163 Va. 908, 927, 177 S.E. 852, 860 (1935); cf. Barnes v. Andrews, 298 F. 614, 618 (S.D.N.Y. 1924) (finding of director negligence but no liability because of failure to prove injury proximately caused by director's breach of duty of care).

There are a number of cases raising duty of care violations wherein the director had a divided loyalty. E.g., Barrett v. Southern Conn. Gas Co., 172 Conn. 362, 378, 374 A.2d 1051, 1059 (1977);

tions will be unable to attract qualified directors in light of both the most recent Delaware decision imposing liability<sup>6</sup> and the perceived insurance crisis.<sup>7</sup> State legislatures have taken a number of approaches.<sup>8</sup> These responses have once again raised the question of charter mongering, with states vying for the corporate chartering statute that would most likely encourage incorporation in that state.<sup>9</sup> The basic approaches are described below.

## I. STATUTORY PROVISIONS DECREASING DIRECTOR ACCOUNTABILITY

**CHARTER LIMITS ON LIABILITY.** At least thirteen states, following Delaware,<sup>10</sup> have authorized corporate charter provisions limiting or eliminating director liability for money damages.<sup>11</sup> These charter option bills have been introduced in a number of other states.<sup>12</sup> This type of cap on personal liability generally is limited to duty of care violations and does not apply when the director has acted in bad faith or has received an improper benefit as a result of the transaction. Furthermore, these provisions do not preclude equitable actions to enjoin director misconduct.<sup>13</sup>

Although Delaware was the initial leader in charter option provisions, other states have taken the lead in the race to the bottom. For example, Virginia

Polk v. Good, 507 A.2d 531, 533 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985).

6. Smith v. Van Gorkom, 488 A.2d 858, 869 (Del. 1985) (imposing liability on corporate directors for approving merger plan after a two-hour meeting and based on a presentation by the corporate president).

7. See, e.g., Veasey, Finkelstein & Bigler, *Responses to the D & O Insurance Crisis*, 19 REV. SEC. & COMMODITIES REG. 263 (1986).

8. See Hanks, *State Legislative Responses to the Director Liability Crisis*, 20 REV. SEC. & COMMODITIES REG. 23, 24 (1987).

9. See, e.g., Coffee, *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759 (1987); Moore & Manning, *State Competition Panel Response*, 8 CARDOZO L. REV. 779 (1987).

10. DEL. CODE ANN. tit. 8, § 102(b)(7) (1986); see generally Balotti & Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5 (1987) (analysis of Delaware law permitting Delaware corporations to limit or eliminate directors' personal liability for breach of fiduciary duty); Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25 (1987) (discussing liability of outside directors under General Corporation Law of Delaware).

11. GA. CODE ANN. § 14-2-171(b) (Supp. 1987); Act of Jan. 30, 1987, ch. 88, 1987 Kan. Sess. Laws 533 (to be codified at KAN. STAT. ANN. § 17-6002); MASS. ANN. LAWS ch. 156B, § 13(b)(1.5) (Law. Co-op. Supp. 1987); MICH. STAT. ANN. § 21.200(209) (Callaghan Supp. 1987); Act of Feb. 25, 1987, ch. 2, § 1, 1987 Minn. Sess. Law Serv. 2 (West) (to be codified at MINN. STAT. § 302A.111(4)); Act of Mar. 18, 1987, ch. 28, § 2, 1987 Nev. Stat. 80 (to be codified at NEV. REV. STAT. ch. 78); Act of Feb. 4, 1987, ch. 35, 1987 N.J. Sess. Law Serv. 171 (West) (to be codified at N.J. STAT. ANN. § 14A:2-7); Act of Apr. 9, 1987, ch. 238, 1987 N.M. Laws 1374 (to be codified at N.M. STAT. ANN. § 53-4-9.1); Act of July 22, 1987, ch. 626, § 1, 1987 N.C. Adv. Legis. Serv. 14 (to be codified at N.C. GEN. STAT. § 55-7(11)); PA. STAT. ANN. tit. 42, § 8364 (Purdon Supp. 1987); Act of Mar. 17, 1987, ch. 340, 1987 S.D. Laws 463 (to be codified at S.D. CODIFIED LAWS ANN. ch. 47-2); Act of May 4, 1987, ch. 273, § 21, 1987 Tenn. Adv. Legis. Serv. 21 (to be codified at TENN. CODE ANN. § 48-2-102(b)(3)); Act of June 17, 1987, ch. 424, § 1, 1987 Tex. Sess. Law Serv. 3943, 3943-44 (to be codified at TEX. REV. CIV. STAT. ANN. art. 1302-7.06); UTAH CODE ANN. § 7-7-3.1 (Supp. 1987).

12. See, e.g., Ware & Williams, *Director and Officer Liability—A Concern of Wisconsin Lawyers and Corporations*, WIS. B. BULL., Dec. 1986, at 9.

13. See statutes cited *supra* note 11.

not only has imposed a cap on liability but also has purported to eliminate the statutory duty of care.<sup>14</sup> In following the Delaware charter option provision, North Carolina eschews the broader exclusion for breaches of the duty of loyalty. Instead, the charter limitation on liability does not apply, *inter alia*, to situations in which the director received an improper benefit or to "acts or omissions not made in good faith that the director at the time of such breach knew or believed were in conflict with the best interests of the corporation."<sup>15</sup> Under the Delaware formulation a director who finds himself in a conflict of interest situation cannot hide behind the cap on liability. On the other hand, in North Carolina the presence of conflicting interests is not sufficient to bar a liability cap. Accordingly, the director who in good faith believes that his action will not harm the corporation, although there is no potential corporate benefit, will be shielded under a North Carolina charter opt-out so long as the director did not benefit. The North Carolina approach thus puts an undue burden on plaintiffs suing directors covered by charter opt-out liability caps. The preferable view, which presumably is in force in Delaware and elsewhere, is that once a conflict of interest situation has been identified, the burden shifts to the defendant to sustain the transaction under attack.<sup>16</sup>

**STATUTORY CAP ON LIABILITY.** Virginia has established a cap on director liability which applies except in cases of willful misconduct or knowing violation of criminal or securities law.<sup>17</sup> The Virginia statute establishes a dollar limit on director liability; the cap can be lowered by charter provision but apparently cannot be raised.<sup>18</sup> Because Virginia imposes a statutory cap on liability rather than allowing, as have Delaware and other states, the inclusion of liability caps in charter provisions, Virginia's cap is mandatory rather than consensual. Because of its nonconsensual nature, the Virginia limitation on liability may well be subject to constitutional challenge.<sup>19</sup>

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14. VA. CODE ANN. § 13.1-692.1 (Supp. 1987).

15. Act of July 22, 1987, ch. 626, § 1, 1987 N.C. Adv. Legis. Serv. 14 (to be codified at N.C. GEN. STAT. § 55-7(11)). The Delaware statute applies only to director liability "to the corporation or its shareholders." In contrast, the North Carolina statute is not so limited. Thus, to the extent that directors owe a fiduciary duty to creditors, the North Carolina cap would apply but the Delaware cap would not. This may be only of academic interest, because directors generally do not owe a fiduciary duty to outsiders. *But see* FDIC v. Sea Pines Co., 692 F.2d 973 (4th Cir. 1982) (when corporation becomes insolvent directors' fiduciary duty shifts from stockholders to creditors).

16. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

17. VA. CODE ANN. § 13.1-692.1 (Supp. 1987). The Virginia statute establishes a liability cap based on the lesser of \$100,000 or the director's cash compensation during the 12 months preceding the act or omission giving rise to liability. Additionally, a lower cap may be established in a corporation's charter. *Id.* § 13.1-692.1A.

18. *Id.* § 13.1-692.1A.

19. *See, e.g.*, Boyd v. Bulala, 647 F. Supp. 781, 789 (W.D. Va. 1986) (statutory medical malpractice liability cap held in violation of Virginia's state constitutional guarantee of the right to a jury trial); Jones v. State Bd. of Medicine, 97 Idaho 859, 555 P.2d 399 (1976) (medical malpractice cap violated equal protection clause), *cert. denied*, 431 U.S. 914 (1977); Carson v. Maurer, 121 N.H. 925, 424 A.2d 825 (1980) (medical malpractice cap violated New Hampshire constitutional guarantee of equal protection under the law); *see also* Wright v. Central DuPage Hosp. Ass'n, 63 Ill. 2d 313, 347 N.E.2d 736 (1976) (provision limiting medical malpractice damages to \$500,000 arbitrary and thus violative of equal protection clause); Arneson v. Olson, 270 N.W.2d 125 (N.D. 1978) (entire medical malpractice act unconstitutional when legislature would not have enacted it without unconstitutional portions); Baptist Hosp. v. Baber, 672 S.W.2d 296 (Tex. Ct. App. 1984) (noting

Recommendations for some sort of limitation on directors' liability began to surface in the early 1970s.<sup>20</sup> The American Law Institute (A.L.I.), in an early draft of *Principles of Corporate Governance*, recommended a dollar cap on directors' liability for breaches of the duty of care<sup>21</sup> but has since taken a more balanced approach. The current draft of the A.L.I.'s *Principles* provides that if a director's breach is not willful, the damages should not be disproportionate to the economic benefits derived by the director from serving the corporation.<sup>22</sup> In making this recommendation, the drafters rejected an elimination of liability, pointing out that the proposed limitation "does not threaten to leave shareholders destitute" and "applies only when the interests of justice so require."<sup>23</sup> The A.L.I. project thus represents an attempt to deal with the perceived liability and insurance crisis and at the same time to continue to protect shareholder interests. Also, like much of the legislation to date, the A.L.I. project's limitation on damages is limited to duty of care violations and does not affect the fiduciary standards of loyalty.<sup>24</sup> Although the A.L.I. project may represent an overreaction to a few scattered cases and a perceived crisis—much of which may have been manufactured by the insurance companies—it tries to strike a balance that is not present in the charter option approach. As noted above, Delaware, in its charter option provision, permits an approach that is more protective of directors than the A.L.I. project, and a few states—most notably Virginia and North Carolina—have gone even further.<sup>25</sup>

**CHANGES IN STANDARD OF CARE.** The traditional formulation has been that a director owes to the corporation a duty of care consistent with the level of

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absence of "quid pro quo" to medical malpractice plaintiffs in holding liability cap unconstitutional), *writ of error denied*, 714 S.W.2d 310 (Tex. 1986) (per curiam). *But see* *Fein v. Permanente Medical Group*, 38 Cal. 3d 137, 695 P.2d 665, 211 Cal. Rptr. 368, *appeal dismissed*, 474 U.S. 892 (1985) (upholding constitutionality of medical malpractice cap); *Florida Patient's Compensation Fund v. Von Stetina*, 474 So. 2d 783 (Fla. 1985) (upholding payouts from patient compensation fund); *Johnson v. St. Vincent Hosp., Inc.*, 273 Ind. 374, 404 N.E.2d 585 (1984) (upholding cap); *Sibley v. Board of Supervisors*, 446 So. 2d 760 (La. Ct. App. 1983) (upholding cap), *aff'd*, 462 So. 2d 149 (La.), *modified*, 477 So. 2d 1094 (La. 1985); *State ex rel. Strykowski v. Wilkie*, 81 Wis. 2d 491, 261 N.W.2d 434 (1978) (upholding annual payments out of fund).

Because the Delaware charter option approach is consensual, arguably it would fare better under constitutional scrutiny.

20. See A.L.I., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 7.17, at 245-46 reporter's note (Tent. Draft No. 6, Oct. 10, 1986) [hereinafter *PRINCIPLES*]; Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 302-09, 330-36 (1981); Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 628-38 (1983); Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 913-15.

21. A.L.I., *PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* § 7.06 (Tent. Draft No. 1, Apr. 1, 1982).

22. *PRINCIPLES*, *supra* note 20, § 7.17.

23. *PRINCIPLES*, *supra* note 20, § 7.17, at 249 reporter's note.

24. It has been suggested that making such a distinction between care and loyalty violations is not justified in light of the similarity in injury to the shareholders. Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: The Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 290-91 (1986).

Unfortunately, the new North Carolina statute takes a similar view and eschews the exclusion for breaches of the duty of loyalty. Act of July 22, 1987, ch. 626, § 1, 1987 N.C. Adv. Legis. Serv. 14 (to be codified at N.C. GEN. STAT. § 55-7(11)); see *supra* text accompanying notes 15-16.

25. See *supra* notes 14-19 and accompanying text.

care taken by an ordinarily prudent person in a like position.<sup>26</sup> The Revised Model Business Corporation Act (Revised Model Act) adds that director action must have been taken in good faith and with the reasonable belief that it is in the best interests of the corporation.<sup>27</sup> The Revised Model Act further provides that directors are entitled to rely on reports and opinions of experts and corporate officers.<sup>28</sup> Similar legislation was pending in North Carolina but was deleted before the adoption of the charter option alternative.<sup>29</sup> Indiana, Ohio, and Virginia have changed the directors' standard of care. Indiana has added to the Revised Model Act by permitting damages only when the director is guilty of "willful misconduct" or "recklessness."<sup>30</sup> The Indiana statute has been followed in model legislation proposed by the National Association of Corporate Directors.<sup>31</sup> Ohio permits damages for breach of care violations only when there is clear and convincing evidence of deliberate intent to injure, reckless disregard of the corporation's best interests, or failure to use ordinary care under the circumstances.<sup>32</sup> The Virginia legislature, in adopting its version of the Revised Model Act, deleted any reference to reasonable conduct, thus imposing on

26. For early formulations of the standard, see *Briggs v. Spaulding*, 141 U.S. 132, 165-66 (1891); *Hun v. Cary*, 82 N.Y. 65, 70-71 (1880). For more recent formulations, see REV. MODEL BUSINESS CORP. ACT § 8.30(a)(2) (1985); A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft no. 4, Apr. 12, 1985). See generally M. FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS (2d ed. 1974) (noting that the precise degree of care required by courts varies).

27. REV. MODEL BUSINESS CORP. ACT § 8.30(a)(1)-(3) (1985).

28. The Revised Model Business Corporation Act provides, in part:

In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

- (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
- (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
- (3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

*Id.* § 8.30(b); accord IND. CODE ANN. § 23-1-2-11 (Burns Supp. 1987); TENN. CODE ANN. §§ 48-813, -815 (1984).

29. See Act of July 22, 1987, ch. 626, § 1, 1987 N.C. Adv. Legis. Serv. 14 (to be codified at N.C. Gen. Stat. § 55-7(11)). The proposed North Carolina legislation also would have adopted the Model Act's indemnification provisions, but as enacted only retains a charter option provision permitting limitation or elimination of director liability in money damages for duty of care violations. See *supra* text accompanying notes 15-16.

30. IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1987); see Note, *The New Indiana Corporation Law: "Reckless" Statute or New Standard?*, 1987 COLUM. BUS. L. REV. 233, 242-45; see also Act of May 29, 1986, act 248, § 1, 1986 Haw. Sess. Laws 443 (to be codified at HAW. REV. STAT. ch. 416) (directors and officers of nonprofit corporation who do not receive remuneration not liable unless grossly negligent).

31. Model Indemnification Statute Proposed for Corporate Directors, 19 Sec. Reg. & L. Rep. (BNA) 689 (May 8, 1987).

32. OHIO REV. CODE ANN. § 1701.59(C)(1) (Anderson Supp. 1986). The Ohio statute "not only place[s] the burden of proof on the party challenging director action, but also impose[s] a more stringent evidentiary standard for proving a breach of a fiduciary duty." Block & Hoff, *Ohio Tightens up on Director Liability*, 197 N.Y.L.J. 5, 6 (Feb. 5, 1987). The Ohio statute is significant in that it also shifts the burden of proof to the complaining party in a potential conflict of interest situation, such as the defense of a hostile takeover. See OHIO REV. CODE ANN. § 1701.59(C)(1) (Anderson Supp. 1986). Traditionally in such a case the director has had the burden of establishing the propriety of the action being challenged.

directors a standard phrased in terms of the good faith exercise of judgment.<sup>33</sup>

**BASIS FOR DIRECTOR DECISIONMAKING.** Another approach to the standard of care formulation has been to expand the factors to be considered by corporate decisionmakers. It has long been suggested that corporate officials have obligations that transcend profit maximization.<sup>34</sup> For example, it has been argued that corporate management should consider all members of the corporate constituency, including employees and localities, that are dependent on the corporation's continuing prosperity. This model has been adopted in other countries.<sup>35</sup> The Indiana corporation statute specifically empowers directors to consider factors not directly related to profit maximization: "A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent."<sup>36</sup>

Such an expansive list of relevant factors can be traced as an outgrowth of the call for more socially responsible corporations.<sup>37</sup> Pennsylvania, Maine, and Ohio have taken a similar approach,<sup>38</sup> which is also being considered in other states.<sup>39</sup> Although not expressly embodied in other statutes, this expanded list of factors arguably is a relevant consideration for any corporate decisionmaker.

33. VA. CODE ANN. §§ 13.1-704, 13.1-883 (Supp. 1987) (prohibiting indemnity for "willful misconduct").

34. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 352-57 (1932); A. CONARD, *CORPORATIONS IN PERSPECTIVE* § 218 (1976); R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 15-32 (1976); Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1145 (1932); Hazen & Buckley, *Models of Corporate Conduct: From the Government Dominated Corporation to the Corporate Dominated Government*, 58 NEB. L. REV. 100, 103 (1978); Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458, 1460 (1964).

35. For example, German corporate law requires labor representation on the board of directors in order to ensure that the interests of the workers are considered in corporate decisions. See A. CONARD, *supra* note 34, at 81-85; Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 25 (1966). A number of American companies have voluntarily permitted labor representatives on the board.

36. IND. CODE ANN. § 23-1-35-1(d) (Burns Supp. 1987).

37. See, e.g., R. NADER, M. GREEN & J. SELIGMAN, *supra* note 34, at 258-60; Branson, *Progress in the Art of Social Accounting and Other Arguments for Disclosure on Corporate Social Responsibility*, 29 VAND. L. REV. 539, 546 (1976); Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391, 397-40.

38. ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1986); OHIO REV. CODE ANN. § 1701.59 (Anderson Supp. 1986); PA. STAT. ANN. tit. 42, § 8363 (Purdon Supp. 1987). The Ohio statute uses a different formulation:

A director, in determining what he reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in his discretion, may consider any of the following:

- (1) The interests of the corporation's employees, suppliers, creditors, and customers;
- (2) The economy of the state and nation;
- (3) Community and societal considerations;
- (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

OHIO REV. CODE ANN. § 1701.59(e) (Anderson Supp. 1986).

39. See, e.g., Hanks, *supra* note 8, at 28 (discussing Wisconsin's efforts).

Notwithstanding the origins of the expanded corporate constituency, such considerations have the indirect effect of lowering the directors' accountability for their decisions. Although not lowering the standard of care applicable to directors, the expansion of factors a board may—and perhaps should—consider will help justify any decision made under the business judgment rule. Considering that the Indiana statute was adopted in 1986, rather than in the 1970s, when corporate social responsibility was a major issue, it is fair to assume that the impetus for this legislation was the desire to insulate directors rather than to encourage corporate social responsibility.<sup>40</sup> It seems clear that the effect of such legislation is to increase the benefit of the doubt given to directors under the business judgment rule. In addition to the questionable merits of such legislation, there is something to be said for leaving the definitions of duty of care and business judgment to the courts, which for more than one hundred years have arrived at workable definitions.<sup>41</sup>

**EXPANDED INDEMNIFICATION.** A number of states, including North Carolina, New York, Indiana, Louisiana, Pennsylvania, Texas, and Wyoming, have greatly liberalized the corporation's power to indemnify directors.<sup>42</sup> For example, New York expressly permits the corporation to indemnify a director for liability to the corporation.<sup>43</sup> The North Carolina statute, enacted hastily in 1986 in response to the fear of losing business to other states, may be similar in effect.<sup>44</sup> The North Carolina statute has a number of flaws.<sup>45</sup> Among other

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40. In a somewhat similar vein, North Carolina has recently adopted statutes designed in part to protect employee interests by regulating companies incorporated elsewhere, but having more than 10% of the beneficial owners of the corporations' voting stock, 40% of their domestic employees, and 40% of their domestic fixed assets located within the state. North Carolina Shareholder Protection Act, ch. 88, § 1, 1987 N.C. Adv. Legis. Serv. 70, amended by Act of May 1, 1987, ch. 124, § 1, 1987 N.C. Adv. Legis. Serv. 1 (to be codified at N.C. GEN. STAT. §§ 55-75 to -80) (requiring that a person acquiring such a company pay to all shareholders the price paid to any one shareholder); North Carolina Control Share Acquisition Act, ch. 182, § 1, 1987 N.C. Adv. Legis. Serv. 48 (to be codified at N.C. GEN. STAT. §§ 55-90 to -98) (requiring that once someone acquires more than 20% of the voting stock, there be a vote of the majority of disinterested shares permitting the control person to exercise the voting rights); see *infra* text accompanying notes 61-66.

41. See A.L.I., *supra* note 26, § 4.01; Subak, *Snapshot of the Law Being Carved in Stone*, 42 BUS. LAW. 761, 763-64 (1987).

42. See IND. CODE ANN. § 23-1-37-8 (Burns Supp. 1987); LA. REV. STAT. ANN. § 12:83(A) (West Supp. 1987); N.Y. BUS. CORP. LAW § 722(C) (McKinney Supp. 1987); N.C. GEN. STAT. § 55-19(a) (Supp. 1986); PA. STAT. ANN. tit. 42, § 8365(a) (Purdon Supp. 1987); TEX. REV. CIV. STAT. ANN. BUS. CORP. ACT art. 2.02-1 (Vernon Supp. 1987); WYO. STAT. § 17-1-105.1(a) (1987); Chernoff & Staples, *New York Expands Power to Indemnify Directors*, 196 N.Y.L.J. 25 (Oct 14, 1986). Bills have also been introduced in Maine and New Mexico. See Hanks, *supra* note 8, at 27. See also Batchelder, *Indemnification of Officers and Directors of Massachusetts Corporations*, 30 BOSTON B.J. 19 (Nov.-Dec. 1986) (exploring Massachusetts' brief and ambiguous statute).

For a general discussion of indemnification, see Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968) (analyzing various means of indemnification and trends in law); Irenas & Moskowitz, *Indemnification of Corporate Officers, Agents and Directors: Statutory Mandates and Policy Limitations*, 7 SETON HALL LEGIS. J. 117 (1984) (discussing concept of indemnification in context of New Jersey statutes).

43. N.Y. BUS. CORP. LAW § 722 (McKinney Supp. 1987).

44. N.C. GEN. STAT. §§ 55-19(a) (Supp. 1986). The statute simply states that indemnification is proper in any action in which the director or officer has not violated his duty of loyalty. *Id.* This would appear to apply to shareholder derivative suits. The New York statute expressly states that indemnification in derivative suits is consistent with the state's public policy. N.Y. BUS. CORP. LAW § 726(e) (McKinney Supp. 1987). There is no such statement in the North Carolina statute. Indeed, it can be argued that the North Carolina indemnification statute does not properly extend to deriva-

things, it permits directors to cause the corporation to indemnify them without the directors being subject to the normal conflict-of-interest statute that otherwise would require a showing of fairness by the directors and approval by the shareholders or by a majority of disinterested directors.<sup>46</sup> The North Carolina indemnification statute thus gives far more power to the directors than the Revised Model Act or the law of other states, that apply the normal conflict-of-interest provisions to director self-indemnification.<sup>47</sup> Furthermore, the North Carolina indemnification statute is poorly drafted. For example, it is clear that the drafters of the North Carolina provision intended to permit indemnification in derivative suits in which the plaintiff is successful. However, unlike New York, the statute does not make this explicit. There is an argument that it would be against public policy to interpret the North Carolina statute to permit the elimination of derivative litigation. The shareholder derivative suit has a firm place in both North Carolina case law and statutes as a means of protecting shareholder interests.<sup>48</sup>

Permitting indemnification of directors found liable in successful shareholder derivative litigation is difficult, if not impossible, to justify. Such indemnification agreements would merely recycle money from the derivative suit defendant to the plaintiff (the corporation) and then from the corporation back to the defendant. The only beneficiaries in this recycling are the lawyers. The same effect can be accomplished by the charter option statutes that permit eliminating director liability in damages for duty of care violations.<sup>49</sup> Although such limitations on liability are highly questionable, they are preferable to the inefficiency of recycling money in derivative litigation.<sup>50</sup>

Perhaps the most troubling aspect of the North Carolina indemnification statute is that, as noted above, directors can indemnify themselves without approval of the shareholders.<sup>51</sup> This is a departure from the traditional rule that contracts between directors and their corporations should be approved by a disinterested body.<sup>52</sup> Statutes such as North Carolina's represent an unwarranted overreaction to concerns about the ability to attract good men and women to

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tive suits when the plaintiff is successful, because to do so would undercut the State's public policy of recognizing the derivative suit as a mechanism for enforcing shareholder rights. See N.C. GEN. STAT. § 55-5 (1982) (authorizing the shareholder derivative suit).

45. A drafting committee of the General Statutes Commission recommended that the Model Act be substituted for the North Carolina provision, but that proposed amendment was dropped due to pressure from one segment of the corporate lobby. The drafting committee includes in its membership several widely respected corporate practitioners, a fact that would seem to lessen the possibility of anti-corporate bias on the part of the committee despite the presence of two law professors among the group.

46. N.C. GEN. STAT. § 55-19(b) (Supp. 1986); see *id.* § 55-30(b) (1982).

47. See, e.g., REV. MODEL BUSINESS CORP. ACT §§ 8.31, 8.50 to 8.58 (1985).

48. N.C. GEN. STAT. § 55-55 (1982); R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE § 14-1 (3d ed. 1983); see *supra* note 44.

49. See *supra* text accompanying notes 10-16.

50. In addition to the inefficiency of the indemnification approach, ironically, it may fail to accomplish the proponents' goals. It is quite common that directors who have been guilty of mismanagement will be seeking indemnification from insolvent corporations and thus will not be protected in such situations.

51. N.C. GEN. STAT. § 55-19(a)-(b) (Supp. 1986).

52. *Id.* § 55-30(b) (1982); REV. MODEL BUSINESS CORP. ACT § 8.31 (1985); see Comment,

corporate boards. As is the case with many of the other recent legislative solutions, the answer has been to throw the baby out with the bath water.

A more reasoned approach, should expansion of the more traditional indemnification rules be desired, is simply to render them nonexclusive and let the traditional director adverse interest statutes control adoption of indemnification agreements. Statutory indemnification is nonexclusive in thirty-one states and the District of Columbia.<sup>53</sup>

EXPANDED AUTHORIZATION TO SEEK INSURANCE. Hawaii has expanded the directors' authority to provide directors' and officers' liability insurance, including the ability to contract with insurers owned by the corporation.<sup>54</sup> Louisiana and Ohio have amended their statutes to enable the board to authorize self-insurance through a trust fund or otherwise.<sup>55</sup>

## II. THE INADVISABILITY OF STATUTORY DILUTION OF DIRECTOR ACCOUNTABILITY—THE RACE TO THE BOTTOM

Many of the above measures have been taken in response to the perceived insurance crisis and feared inability to attract good directors—especially outside directors—to corporate boards. Although this fear, like the availability of insurance, is a real concern, the appropriate response is to take a cautious approach that would balance the interest of compensating injured shareholders against the interest of ensuring that onerous burdens are not placed on corporate directors.

It would appear that many of the states have gone too far in their reaction to the perceived director liability "crisis."<sup>56</sup> Because directors manage the shareholders' investment, they should be held accountable for their misdeeds. The age-old analogy of corporate directors to trustees is not misplaced.<sup>57</sup> Some institutional investors have refused to cast their votes in favor of charter amendments that take advantage of the Delaware charter option to eliminate liability. These institutional investors reason that to vote otherwise would be contrary to their investors' best interests. Another piece of evidence as to the inadvisability of recent legislative action is a Securities and Exchange Commission study, which indicates that Ohio's expansion of the basis for director decisionmaking<sup>58</sup>

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*Corporate Director Conflicts of Interest: The Fairness Test and its Application Under Existing Statutory Provisions and Proposals for Statutory Reform*, 53 TENN. L. REV. 799 (1986).

53. See Hanks, *supra* note 8, at 29.

54. Act of April 18, 1986, act 53, §§ 1-2, 1986 Haw. Sess. Laws 6 (to be codified at HAW. REV. STAT. § 416-35(h)).

55. LA. REV. STAT. ANN. § 12:83(F) (West Supp. 1987); OHIO REV. CODE ANN. § 1701.13(E)(7) (Anderson Supp. 1986).

56. *Cf. Arneson v. Olson*, 270 N.W.2d 125 (N.D. 1978) (finding insufficient rational connection between the abatement of the medical malpractice liability "crisis" and a statutory cap on liability); *Baptist Hosp. v. Baber*, 672 S.W.2d 296 (Tex. Ct. App. 1984) (same). *But cf. Johnson v. St. Vincent Hosp., Inc.*, 404 N.E.2d 585 (Ind. 1984) (finding a rational basis for medical liability cap); *Pendergast v. Nelson*, 199 Neb. 97, 256 N.W.2d 657 (1977) (statutory requirement that medical malpractice claims be submitted to a review panel bears rational relationship to legislative purpose of ending public health crisis).

57. In making this analogy courts have always given more leeway to corporate directors than to bona fide trustees.

58. See *supra* notes 32 & 38.

has adversely affected the stock price of companies subject to the Ohio statute.<sup>59</sup>

Although much of the new wave of statutory reforms arguably has some merit, legislatures have adopted the reforms relatively quickly and without the type of legislative deliberation normally attached to major statutory reform. Such precipitous action may rekindle claims of "law for sale."<sup>60</sup> Unfortunately, three recent North Carolina statutes are particularly susceptible to this attack.

First, the North Carolina Shareholder Protection Act<sup>61</sup> was hurried through the legislature in a matter of days without any of the traditional legislative process. The bill was adopted notwithstanding strong opposition from prominent members of the corporate bar, the North Carolina Bar Association, and the General Statutes Commission's corporation act drafting committee.<sup>62</sup> Most significantly, the Act has a number of drafting deficiencies.<sup>63</sup> Within a month, in response to the threatened takeover of Burlington Industries, the legislature took two measures. First, it expanded coverage of the Shareholder Protection Act to foreign corporations having more than forty percent of their domestic assets and employees within the state.<sup>64</sup> Within a matter of days the legislature enacted the Control Share Acquisition Act,<sup>65</sup> which originally was drafted to cover corporations with more than fifty percent of their domestic assets and employees within the state, but was rewritten to ensure that Burlington was covered by the statute. Although both statutes arguably have some merit, they were rushed through the legislature and clearly suffer as a result. As noted above, the Shareholder Protection Act contains a number of drafting ambiguities. Equally troublesome is the manner in which the Control Share Acquisition Act was tailored to a specific fact situation in a way that may make it unconstitutional.<sup>66</sup>

The third questionable North Carolina statute adopted was an expanded

59. See *Ohio Companies' Stock Prices Dropped After Takeover Defenses Were Bolstered*, 19 Sec. Reg. & L. Rep. (BNA) No. 21, at 741 (May 22, 1987).

60. See Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

61. North Carolina Shareholder Protection Act, ch. 88, § 1, 1987 N.C. Adv. Legis. Serv. 70, amended by Act of May 1, 1987, ch. 124, § 1, 1987 N.C. Adv. Legis. Serv. 1 (to be codified at N.C. GEN. STAT. §§ 55-75 to -80).

62. The statute was opposed mainly because it was poorly drafted. Except for a provision requiring an extraordinarily high (95%) shareholder vote to waive its applicability, the statute was not opposed on its merits.

63. For example, the Act applies to "business combinations" but does not clearly define that term. Second, the Act purportedly does not let corporations opt out once 90 days following its effective date have elapsed. N.C. GEN. STAT. § 55-79(ii) (1987). However, this limitation can be circumvented indirectly by forming a new corporation with an opt-out provision in its initial articles of incorporation and then merging the existing business into the new corporation. See *id.* § 55-79(iv).

64. *Id.* § 55-75(3a).

65. North Carolina Control Share Acquisition Act, ch. 182, § 1, 1987 N.C. Adv. Legis. Serv. 48 (to be codified at N.C. GEN. STAT. §§ 55-90 to -98).

66. It is generally believed that only the state of incorporation should try to govern corporate internal affairs. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 11 comment 1 (1971); Francis, *The Domicil of a Corporation*, 38 YALE L.J. 335, 357 (1929); Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1965). Excessive regulation by a host state of corporations incorporated elsewhere may impose an undue burden on interstate commerce in contravention of the commerce clause of the federal Constitution.

version of Delaware's charter option liability cap.<sup>67</sup> In an attempt to strike a reasonable balance between the fear of unfounded and thus harassing shareholder suits and the need to hold directors to an appropriate standard of conduct, a drafting committee of the North Carolina General Statutes Commission recommended a charter option provision that would have permitted a cap of \$100,000. The proposed legislation also would have revised the statutory duty of care and would have adopted the Model Act's indemnification provisions. The pro-shareholder aspects of the legislation—permitting only a cap rather than the elimination of liability, the rephrased duties of care, and the Model Act's indemnification provisions—all were dropped by the time the bill passed. As a result, North Carolina has one of the most permissive charter option provisions, surpassing Delaware in the race to the bottom.

Even aside from the individualized shortcomings of the particular statutes discussed above, the statutes raise a more general problem of private legislation. We seem to be approaching a time when legislatures can be easily persuaded by lobbyists seeking to further particular client interests. As a consequence, legislatures fail to consider the overall picture. Other states, including Connecticut,<sup>68</sup> have rushed through second-generation takeover statutes.<sup>69</sup> The precipitous action of many states in responding to the director and officer insurance crisis seems to fall within the same category. If in fact a problem exists, it should be carefully studied, giving consideration to various alternative solutions. The only solutions considered to date have been various methods of reducing directors' standard of accountability.

Although one would hope that legislators would learn from the past, that does not seem to be the case. In the 1970s, when it last appeared that states were actively vying against each other in the race to the bottom, there were many active calls for federal chartering of corporations.<sup>70</sup> The states tempered their quest for the trophy in the race, state courts became more responsive to shareholder concerns,<sup>71</sup> and the calls for federal involvement ended. The period during which many called for federal chartering was not the first time that the issue reached major proportions.<sup>72</sup> We are now beginning once again to see agitation for federal action, at least with regard to directors' responses to hostile takeover

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67. See *supra* notes 10-16 and accompanying text.

68. See Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 727 n. 51 (1987).

69. See *id.* at 738.

70. Cary, *A Proposed Federal Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Coffee, *supra* note 9; Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915 (1972); Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71 (1972); Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89 (1972).

71. *E.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); see *Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1986). *But cf.* *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (cutting back on *Singer*).

72. See Brabner-Smith, *Federal Incorporation of Business*, 24 VA. L. REV. 159 (1937); Grosscup, *The Federal Corporation Problem and the Lawyer's Part in its Solution*, 39 AM. L. REV. 835 (1905); Reuschlein, *Federalization—Design for Corporate Reform in a National Economy*, 91 U. PA. L. REV. 91 (1942); Snapp, *National Incorporation*, 5 ILL. L. REV. 414 (1911).

attempts.<sup>73</sup> It is to be hoped that history will repeat itself and the states will retrench from their vigorous quest for the bottom. Otherwise, it will be necessary for Congress to intervene in order to restore the balance that the law relating to director liability previously reflected.

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73. See, e.g., Coffee, *supra* note 9; Dingell, *Markey Introduces Bill to Eliminate Abuses in Tender Offers*, 19 Sec. Reg. & L. Rep. (BNA) 623 (May 1, 1987); Karmel, *Will Takeover Abuses Lead to Federal Corporation Law?*, 197 N.Y.L.J. 1 (Feb. 19, 1987).