CHAPTER 3

DUTY OF DILIGENCE

SYNOPSIS

§ 3.01 Duty to Exercise Care.
§ 3.02 Standard of Care: Statutory.
§ 3.03 Standard of Care: Common-Law.
§ 3.04 Degree of Culpability.
§ 3.05 Reliance on Advice of Counsel or Experts.
§ 3.06 Reliance on Reports of Committees.
§ 3.07 Reliance on Corporate Officers and Employees.
§ 3.08 Reliance on Corporate Books and Records.
§ 3.09 Ignorance of Corporate Books and Records.
§ 3.10 Shirking Responsibility; Inexperience.
§ 3.11 Supervision of Officers and Employees.
§ 3.12 Duty to Monitor.
§ 3.13 Participating in or Causing Corporate Tort or Crime.
§ 3.14 Misuse of Corporate Funds; Waste.
§ 3.15 Directors’ Liability as Shareholders.
§ 3.16 Enforcement of Liability.
§ 3.17 Extent of Liability; Damages.
Corollary References

§ 3.01 Duty to Exercise Care.

Because directors represent the financial interests of shareholders and others, they have an affirmative duty to act diligently and prudently in managing the corporation’s affairs. This responsibility is called the duty of diligence or duty of care. Usually, the question of whether a director has met the duty of care is a question of fact to be decided on a case-by-case basis.\(^1\) Where directors make decisions likely to affect shareholder welfare, the duty of due care requires that the decisions be made on the basis of “reasonable diligence” in gathering and

\(^1\) Gearhart Indus., Inc. v. Smith Int’l, Inc., 741 F.2d 707, 720 (5th Cir. 1984); McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000).
§ 3.01 LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 3-2

considering material information. In other words, a director’s decisions must be reasonably informed ones.2

A director’s “unyielding fiduciary duty to the corporation and its shareholders”3 does not tolerate faithlessness or self-dealing. It requires the director to recognize that he or she acts on behalf of others. Representation of the financial interests of others imposes an affirmative duty to protect those interests.4 A director’s duty to exercise informed business judgment is in the nature of a duty of care.5 Its elements are defined both by statute and by court decisions, as Sections 3.02 and 3.03, infra illustrate. However, most of the rules describe the manner in which directors should perform their duties; there is little, if anything, to define completely the parameters of the duties.6

One commentator points out that litigation involving duty of care has concerned “discrete judgments by boards” and the courts’ responses have been “addressed to individual discreet events.”7 As a consequence, the decisions do not spell out what directors should do or not do, when they exercise due care. The decisions merely state that what was done, or not done, in a particular situation did, or did not, constitute such care. The statutes and rules merely reflect the court decisions rendered to date.

As the Delaware County of Chancery has discussed the duty of care imposed upon corporate directors and officers:

Director liability for a breach of duty to exercise appropriate attention may, in

---


theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or “negligent.” Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss. . . .

[Compliance with a director’s duty of care] can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury, considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational,” provides no ground for director liability as long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule — one that permitted an “objective” evaluation of the decision — would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by deep respect for all good faith board decisions. . . . Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention.8

§ 3.02 Standard of Care: Statutory.

At least three-fourths of the states have enacted duty-of-care statutory provisions. Most of those states follow a former version of Section 8.30(a) of the Revised Model Business Corporation Act, which provides:1

---


1 The ABA Committee on Corporate Laws of the Section of Business Law has made significant changes to § 8.30. See 53 BUS. LAW. 157 (Nov. 1997). For example, § 8.30 is now reads in part:

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with care that a person in a like position would reasonably believe appropriate under similar circumstances.

Because changes to the model act are neither immediately nor automatically reflected in state statutes, the impact of the changes will be gradual. Similarly, the ABA Committee on Corporate Laws revised § 8.42, the section which addresses the duties of officers. The revised version continues to employ a form of the “ordinarily prudent person” standard. The Official Comment to § 8.42, however, concedes that the business judgment rule has application to acts of corporate officers. Unfortunately, the text of the statute does not emphasize the role of the business judgment rule in protecting the decisions of officers and may create unnecessary confusion in the D&O liability arena. See Hansen, The Business Judgment Rule: Is There Any Doubt It Applies to Officers?, Corporation, Section 2, Vol. LXX No. 17 (Aspen Law & Business 1999).
§ 3.02 LIABILITY OF CORPORATE OFFICERS AND DIRECTORS

A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

In four states, Alaska, California, Pennsylvania and Washington, the statutes add specific provisions requiring “reasonable inquiry.” In those states and generally, court decisions uniformly call upon directors and officers to be attentive and alert and to make inquiries when circumstances would warn a reasonable director or officer of a need to inquire.2

The American Law Institute’s Principles of Corporate Governance: Analysis and Recommendations suggests standards substantially identical to those mentioned above and further proposes that a director or officer who makes a business judgment in good faith fulfills his or her duty of care if the director or officer (i) is not interested (§ 1.23) in the subject of the business judgment, (ii) is informed to the extent he or she believes appropriate, and (iii) rationally believes the judgment is in the best interests of the corporation.3

Reliance by courts on the American Law Institute’s Principles of Corporate Governance: Analysis and Recommendations is well illustrated in a 1995 Third Circuit decision in which the court refers to it as “the new Restatement of Corporate Governance.” In a note, the court quotes from the Comment to Section 4.01 as its sole authority for the point that the application of duty of care standards is heavily fact-oriented.4

The statutory requirements concerning a director’s duty of care reflect the “good faith” concept embodied in the business judgment doctrine and a well-established definition of ordinary care taken from the common law.5 The Model Act does not use the term “fiduciary” to describe the duty of care on the premise that it could be confused with the unique attributes and obligations of a

3 § 4.01. This aspect of the proposal is discussed in some detail supra Chapter 2.
5 See discussion supra § 2.07; Dellastatious v. Williams, 242 F.3d 191, 195 (4th Cir. 2001) (applying Virginia law).
fiduciary established in the law of trusts. The Model Act is notably silent as to what a director should consider in determining what he or she reasonably believes to be in the best interests of the corporation. Adoption of the Model Act standard does not necessarily result in abrogation of the business judgment rule.

Statutes imposing specific responsibilities and liability on directors have been enacted in some states. In Ohio, for example, there are express provisions relating to false reports or statements about the corporation or its business and false entries in the corporate records; failure to maintain and furnish certain records; unlawful dividends, distributions of assets and loans to officers, directors, or shareholders; and the exercising of corporate powers or authority after the articles have been canceled, or the corporation has been dissolved.

The Delaware statutes and those of most other states contain express provisions relating to unlawful dividends and unlawful stock purchases or redemptions; purchasing the corporation’s own shares when its capital is impaired, failure to publish notice of reduction of capital, willful refusal or neglect to produce a list of stockholders, and payment of the corporation’s debts.

Louisiana statutes provide that a director or officer can be held liable for money damages for grossly negligent breach of the duty of care. The statute provides liability for a claim for grossly negligent breach of the duty of care, and a more egregious claim of breach of fiduciary duty. In Louisiana, grossly negligent breach of the duty of care does not constitute a breach of fiduciary duty “unless it is coupled with fraud, a breach of trust or other ill acts.”

Beginning in 1986, several state legislatures enacted statutes limiting the civil

---

8 OHIO REV. CODE ANN. § 1701.93.
9 OHIO REV. CODE ANN. § 1701.94.
10 OHIO REV. CODE ANN. § 1701.95.
11 OHIO REV. CODE ANN. § 1701.97.
14 LA. STAT. REV. § 6:291.
§ 3.02 LIABILITY OF CORPORATE OFFICERS AND DIRECTORS

liability of corporate directors in response to the crisis that had occurred in the areas of liability and insurance for such persons. Chapter 16 discusses the nature and scope of such legislation. However, even in states adopting liability limitations, areas exist that are not covered and to which the duty statutes discussed herein still apply. Typical examples are equitable relief, including injunction and rescission, and claims arising out of unlawful dividends, distributions and stock purchases. Also, most of the liability limiting statutes exclude distribution and stock purchase liability from the limitations.

Duties imposed under federal statutes and rules of federal regulatory bodies must also be understood. Court decisions of particular significance, arising under federal laws and regulations, are discussed in Chapters 13, 14 and 15, and only brief reference is made here to the important provisions of the various federal securities laws and regulations promulgated thereunder. Of course, state liability limitation statutes cannot affect liabilities imposed by federal laws.

The Securities Act of 1933, 17 the Securities Exchange Act of 1934, 18 the Public Utility Holding Company Act of 1935, 19 the Trust Indenture Act of 1939, 20 the Investment Company Act of 1940, 21 and the Investment Advisers Act of 1940 22 all have as their fundamental purpose the substitution of “a philosophy of full disclosure for the philosophy of caveat emptor” and thus the achievement of “a high standard of business ethics in the securities industry.” 23 Amendments to these statutes, including amendments to the Securities Exchange Act of 1934 made in 1964 and 1966, 24 relate to special protection for investors. Requirements of the amended federal laws dealing with registration of securities, 25 periodic and other reports, 26 solicitation and use of proxies, 27 registration of over-the-counter

---

3-6.1 DUTY OF DILIGENCE § 3.02

brokers and dealers and information and reports required of certain issuers, 28

(Text continued on page 3-7)
