When addressing the role of the board of directors in the governance of modern corporations, it is helpful to discuss two issues at the outset: the duties owed by a director (and collectively by the board as a body) and to whom those duties are owed. By generally addressing these issues first, a more specific analysis of the boards’ role in corporate governance becomes meaningful.

What Duties Does a Director Owe?

It often is said that directors, in managing the business and affairs of a corporation, owe duties of care and loyalty. Delaware’s statutory law requires that the “business and affairs of every [Delaware] corporation . . . shall be managed by or under the direction of a board of directors.” This statutory mandate contemplates either direct “hands-on” management (“shall be managed by”) or delegation to full-time professional managers who report to the board (“managed . . . under the direction of”). The Model Business Corporation Act and the Corporate Director’s Guidebook follow the same formulation. Indeed,
the Delaware Supreme Court has recognized that “[t]he realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company.” Obviously, most boards choose to delegate daily management of the company to a carefully chosen chief executive and professional staff.

As one might expect, the specific steps any board of directors takes to fulfill its duty to manage or oversee the management of an enterprise are not easily cataloged. Practically, and most broadly, managing a large company involves giving careful attention to the selection of competent senior management, establishment of institutional norms and procedures, review and input into management-formulated strategy (or, in appropriate cases, actual formulation of strategy), and a careful and continuous monitoring of the performance of senior management and the enterprise itself. In the face of more recent developments, boards have also placed a renewed emphasis on understanding and monitoring risk.

Classic formulations of the duties of care and loyalty serve to “flesh out” how directors’ duty to manage must be discharged. Under Delaware law the duty of care is said to require directors to appraise themselves of all reasonably available material information before taking action, i.e., to act in a fully informed manner after the exercise of due diligence that is appropriate under the circumstances. The duty of care also governs the care that directors exercise when they delegate their responsibilities and rely on others for information. Similarly, the duty of loyalty requires directors to discharge their duties unselfishly, in a manner designed to benefit only the enterprise and not the directors personally.

The Delaware courts have also recognized other duties, the duty of “oversight,” the duty of good faith, and the duty of “disclosure,” in particular. Those duties are not fiduciary duties separate from directors’ duties of care and loyalty; they are, instead, specific applications of the general fiduciary duties that directors owe.

The duty of oversight involves directors’ carrying out their statutorily mandated duty of supervision. That is, directors must take certain steps to ensure that the day-to-day managers of the corporation are in fact properly managing the corporation’s business and
affairs. Accordingly, directors must ensure that management has put in place an information and reporting system designed to ensure that the board receives “timely, accurate information” sufficient to keep the board informed about the company’s and management’s performance. Then, if a director has knowledge of facts suggesting that the company faces a material issue, the duty of oversight requires that the director initiate board or management consideration of the problem. Conceptually, an active understanding of risk also falls under the “duty” of oversight.

The “duty” of good faith is best conceived of as a practical application of the duty of loyalty, and the case law recognizes it as such. Thus, there are circumstances where a disinterested board could be held to have violated the duty of loyalty. For example, a director violates his or her duty to act in good faith if he or she he “intentionally acts with a purpose other than that of advancing the best interests of the corporation,” “acts with the intent to violate applicable positive law,” or “intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his [or her] duties.” While such conduct will be rare in practice, the law does recognize the possibility that a director with nothing to gain could still act disloyally or in bad faith.

The duty of full and fair disclosure imposed under Delaware law is distinct from the disclosure duties imposed by federal law. The duty usually arises in the context of a board submitting matters to stockholders for a vote. In that context, the duty of full disclosure requires directors “to disclose fully and fairly all material information within the board’s control when it seeks stockholder action.” Similarly, if directors volunteer information to stockholders, “the information must be stated truthfully and candidly.” Whether or not information is “material” to a particular decision is measured by the same test used under federal disclosure law.

To Whom Does a Director Owe Duties?

Having set forth in a broad way the duties owed by a director, the next question follows: To whom are those duties owed? At the out-
set, it may be helpful to address a common misconception on this point often found among directors elected or appointed by a special constituency, for example, a large stockholder. Such a director does not owe any special duties to the constituency that caused his or her election. As the Guidebook correctly states, “[e]ach director works for the benefit of the corporation and all of its owners. This is true even if a director is nominated or designated by a subset of the shareholder body (e.g., holders of preferred stock who may have special rights to elect a director), elected in a proxy contest, or appointed by the board to fill a vacancy.”

In discharging his or her duties as a director, an individual appointed to the board by a special constituency must also understand that, as a director, the individual owes duties to maintain in strict confidence non-public information reviewed as a board member, as well as information relating to the deliberation of the board. Thus, for example, a director appointed to a board by a major investor is not privileged to share confidential information learned by the director in her capacity as such with the investor. While we recognize that this admonition may not always be heeded, directors who share confidential, non-public information outside the boardroom risk a finding of breach of fiduciary duty. This is especially an issue in the public company engaged in a potential transaction, where the use of confidential non-public information could have substantial implications under the federal securities laws for both the director and the corporation.

The simple answer to the question “to whom are duties owed?” is that directors owe their duties to the shareholder-owners of the enterprise that the directors manage. This sensible answer finds its roots in the very reason for the existence of a director’s duties. Directors owe duties of a fiduciary nature because the property they manage is not their own, a necessary result of the separation of ownership and control that has characterized the development of the corporate form. It has been said, then, that because it was the shareholders’ property that directors controlled, it was to the owners of that property that “fiduciary” duties flowed.
Notwithstanding the soundness of the logic apparent in this view, the law has developed significantly since this rule of law was first announced. Today, one could argue that both the precise nature of the duties owed and the group to whom those duties run shifts based upon the economic condition of the firm and related external factors. The technically correct statement of Delaware law is that directors owe a fiduciary obligation to “the corporation and its shareholders.” That is, duties to the shareholders usually prevail in the case of a conflict, but directors’ duties to the “corporation” may require the consideration of other constituencies.

Under this model, a director’s duties (and those to whom the duties are owed) can be imagined to fall along a continuum, influenced importantly by forces outside the control of the enterprise. At one end of this continuum is the case of the solvent corporation, the sale of which is “inevitable.” Directors of that corporation owe duties to one group and one group only—the shareholder-owners of the enterprise. In this context, the duties of the directors come to this: to act in a fully informed manner to maximize the return to shareholders from the sale. At the other end of the continuum is the company that is not for sale but is actually insolvent. When the corporation is insolvent, the duties that the directors owe to the corporation may be enforced by the creditors as well as the stockholders. Between these two poles is where the great majority of boards will operate. Directors of companies not clearly “for sale” and not “actually insolvent” owe duties to the company’s shareholders and to the corporation itself. To say as much, however, raises more questions than it answers. What is “the corporation” and, if it is something more than merely the sum of its shareholders, how do the directors reconcile conflicts between duties to shareholders and duties to the corporation?

The Traditional Model and the Focus on Other Constituencies

The traditional model of corporate governance provided a complete answer to the questions raised previously: A corporation was nothing more or less than the sum of its owners’ aggregate interests and
the object of the enterprise was solely value maximization. Two important assumptions underlying this model seem to have been that the interests of shareholders would always be consistent and would always coincide with the interests of the entity itself.

Neither assumption has survived recent developments unscathed. There are clearly times when the interests of shareholders themselves fail to coincide. For example, the short-term orientation of the professional arbitrageur often has been contrasted with the longer-term view of the “investor.” It follows, therefore, that if shareholders themselves cannot be said to share common interests in all cases, any governance model that views shareholders as monolithic and identical to the corporate enterprise itself is outmoded.

Moreover, the view of the enterprise itself has expanded dramatically. No longer is the corporate entity viewed as simply a collection of shareholders. Instead, some modern legal theorists view the corporate enterprise as a varied collection of stakeholders: employees, creditors, suppliers, community groups, etc. Modern corporate legal theory is, however, less than satisfactory in answering the directors’ practical dilemma: When faced with conflicts between the interests of corporate stakeholders and stockholders, how should the conflicts be resolved?

In all but the most extreme circumstances, it still appears that the director of a solvent corporation may safely resolve conflicts between stockholder and stakeholder interests in favor of stockholders. Most of the state corporate statutes that address the subject permit, but do not require, that a director, when considering the “best interests of the corporation,” take into account the effects of the action upon nonstockholder constituents, including the corporation’s suppliers and customers and the communities in which the enterprise has offices. Connecticut requires directors of corporations chartered there to take such factors into consideration in change-of-control situations.

Delaware has no such statute, and the Delaware courts have lent credence to the consideration of nonstockholder interests in certain limited contexts. In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court, in examining a defensive measure by
a target board faced with a hostile bid, stated that directors’ concerns could legitimately include factors such as “the impact on ‘constituen-
cies’ other than shareholders (creditors, customers, employees, and perhaps even the community generally).”33 Soon after, however, the Supreme Court carved back on this concept in Revlon, Inc. v. MacAn-
drews & Forbes Holdings, Inc.34 The Court in Revlon was faced with a target board who had favored one bidder over another in part due to benefits that the bidder offered to the target’s noteholders. The Court stated that a board “may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.”35

As to the great number of decisions that fall outside this special exception, however, the answer is less clear. In states that have ad-
opted statutes such as those found in Pennsylvania, which permit the board, in considering the interests of other constituencies, not to treat the interests of any one constituency (such as shareholders) as dominant, one could argue that directors could make decisions that benefit only stakeholders. While this conclusion is not clear, outside of these few states the common law counsels that directors who act in preference for stakeholder interests at the expense of stockholders’ interests do so at their own peril without a powerful case that preferring stakeholders’ interests is clearly in the long-term best interests of the enterprise (and, therefore, indirectly consistent with long-term shareholder value maximization) or directly in the long-
term best interests of shareholders.36

The Closely Held Corporation

Having reviewed elemental principles of corporate governance, we now turn briefly to note those special statutory provisions applicable to the governance of the closely held corporation, as well as some of the practical aspects of acting as a director of such a corporation.

At the outset, it may be helpful to define a “closely held” corpo-
ration, a term that has different meanings in federal tax law, state corporation law, and common usage. Although as a matter of com-
mon usage a “close corporation” is one that is not widely held, under
Delaware law, as under the corporation statutes of several states, a close corporation has a meaning defined by statute.

A Delaware close corporation is one that includes in its certificate of incorporation requirements that: (1) share ownership is evidenced only by certificated securities held by no more than thirty holders of record; (2) all of the stock of the company is subject to some restriction on transfer; and (3) no public offering of the shares of the company is permitted.37

Governance of a statutory close corporation may differ significantly from governance of other corporate entities. For example, under the Delaware statutes, stockholders of a close corporation holding a majority of the stock of the company can, in certain circumstances, agree in writing to restrict the discretion or power of the board of directors of the company to manage the “business and affairs” of the enterprise,38 and such an agreement is not invalid simply because it restricts directorial discretion, even if it addresses the division of the firm’s profits or the payment of dividends,39 traditionally matters relegated solely to directorial discretion.

In the presence of such a contract, the directors of the close corporation are statutorily relieved of liability “for managerial acts or omissions ... to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such agreement.”40

Likewise, the Delaware statute permits the certificate of incorporation of a close corporation to provide that the “business of the corporation shall be managed by the stockholders... rather than by a board of directors,”41 effectively supplanting the role of the board in corporate management. If the charter contains such a provision, stockholders are “deemed” to be directors and are “subject to all liabilities of directors.”42

In short, the Delaware close corporation statute allows owners of a close corporation to vary the ordinary role of directors in corporate governance and, in one type of arrangement, to abolish altogether the board of directors. Clearly, an individual invited to become a director of such an enterprise will want to examine carefully the certificate and bylaws of the entity, as well as all pertinent agree-
ments by stockholders of the company relating to governance, before accepting a directorship, to understand fully the role of the director in the company, as well as the scope of the responsibility that he or she is being asked to undertake.

Notes

Portions of this chapter and others in this book have appeared previously in the Corporate Practice Series (BNA), No. 63, The Board of Directors (1993), and have been used herein with permission.

2. 8 Del. Code Ann. § 141(a).
12. In re Caremark, 698 A.2d at 970.
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15. Reviewing courts make their liability determinations on a director-by-director basis. See In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005), aff’d, 906 A.2d 27; In re Emerging Comm’ns, Inc. S’holder Litig., C.A. No. 16415 (Del. Ch. May 3, 2004, revised June 4, 2004). Thus, individual directors have been found to be personally responsible in connection with a transaction where other members of the same board were held to be exculpated. See In re Emerging, C.A. No. 16415, slip op. at 103-16.
24. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); see also Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242 (Del. 2009); Paramount Commc’ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994). Much has been written about a director’s duties in the so-called Revlon context. This topic is explored at greater length in Chapter 3.
26. Of course, this view is not unanimous. Under Pennsylvania statutory law, for example, the director is required to “stand in a fiduciary relation to the corporation.” 15 PA. CONS. STAT. ANN. § 1712(a) (emphasis added).

27. See, e.g., Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); William T. Allen, *Corporate Takeovers and Our Schizophrenic Conception of the Business Corporation* at 5-10 (Dec. 3, 1991) (Univ. of Pa. Institute of Law and Economics) [hereafter “Corporate Conception”] (citing *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919)), which the author refers to as “as pure an example as exists” of this model of the corporation); cf. also *Roundtable, supra* note 14, at 243 (“A corporation has as its prime purpose the long term optimization of economic outcomes.”).

28. See, e.g., *In re IBP, Inc. S’holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001); Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989) (where the company justified issuing a large block of stock to a so-called “white knight” during a proxy contest on grounds that, *inter alia*, such issuance would tend to neutralize the block of shares then believed to be held by short-term speculators and arbitrageurs); cf. ABA Comm. on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2268 (1990) (“Often the shareholder’s interest in the corporation is transitory, frequently a matter of days or weeks....”).


30. The first such statute was adopted by Pennsylvania in 1983. 42 PA. CONS. STAT. ANN. § 8363(b). Most of the statutes that track this model apply to all board decisions; some are limited to change-of-control situations. Ohio allows the board to go further and consider how its actions affect the economy of Ohio and the United States and related societal considerations. OHIO REV. CODE ANN. § 1701.59(E) (2)-(4). These so-called “other constituency statutes” have been roundly criticized. See, e.g., James J. Hanks, Jr., *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come*, INSIGHTS, Dec. 1989, at 20.

32. 493 A.2d 946 (Del. 1985).
33. Id. at 955.
34. 506 A.2d 173 (Del. 1986).
35. Id. at 182.
36. Reviewing the seminal Delaware decisions outlined previously, the American Bar Association (ABA) Committee on Corporate Laws concluded in 1990 that, with respect to the “other constituency” debate, “the Delaware courts have stated the prevailing corporate common law in this country.” Other Constituencies Statutes, supra note 38, at 2261. The Committee also concluded that, without clearly defined legislative intent, the various constituency statutes “should be interpreted in a manner consistent with the existing common law.” Id. at 2254.
37. 8 Del. Code Ann. § 342. In addition, Section 343 of the statute requires that the heading of the company’s certificate of incorporation state that it is a close corporation.
38. Id. § 350.
39. Id. § 354.
40. Id. § 350.
41. Id. § 351.
42. Id.