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The Proper Standard For Directors' Negligence Liability

Larry D. Soderquist*

I. INTRODUCTION

For half a century, the law on directors' negligence liability has been in a muddle. The problem began when a New York trial court wrongly decided *Litwin v. Allen*,¹ the long-time leading case holding directors liable for negligent management,² without a jurisprudential underpinning and without an understanding of just what was behind the directors' conduct. Difficulties continued when succeeding cases failed either to correct the problems inherent in *Litwin* or even to provide directors with guidance on how to protect themselves from liability.³ The last major directors' liability case, *Smith v. Van Gorkom*,⁴ so scared directors and their insurers⁵ that the Delaware legislature, followed to date by the legislatures of almost two-thirds of the other states, passed a statute allowing corporations to eliminate directors' liability for negligence, with the sole proviso that directors must act in good faith.⁶ It will be the job of courts to add content to these new laws by determining what "good faith" means in this context. Furthermore, it will be up to legislatures that have not yet followed Delaware's lead to decide if they are going to do so.

What courts and legislatures need now is what they have

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1 25 N.Y.S.2d 667 (1940).

2 One indication of *Litwin's* influence has been its extensive use in corporation law casebooks. See, e.g., W. CARY, CORPORATIONS: CASES AND MATERIALS 514 (4th ed. 1969); J. DEUTSCH & J. BIANCO, LAW OF CORPORATIONS: WHAT CORPORATE LAWYERS DO 481 (1976); H. HENN, CORPORATIONS: CASES AND MATERIALS 419 (1974); R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 683 (4th ed. 1990); R. JENNINGS & R. BUXBAUM, CORPORATIONS: CASES AND MATERIALS 177 (5th ed. 1979) (*Litwin* referred to as "the leading case"); L. SODERQUIST & A. SOMMER, CORPORATIONS: A PROBLEM APPROACH 199 (2d ed. 1986); D. VAGTS, BASIC CORPORATION LAW 227 (2d ed. 1979).

3 See, e.g., Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U. L. REV. 1341, 1342-50 (1977).

4 488 A.2d 858 (Del. 1985).

5 See *infra* note 45 and accompanying text.

6 See *infra* notes 46-50 and accompanying text.

needed all along but have not had: theoretical and experiential bases for determining the liability of directors for negligence. After examining judicial and legislative developments that have brought us to the present state, this Article will postulate such bases and then evaluate the Delaware approach in light of these bases.

II. WHAT COURTS HAVE TOLD DIRECTORS ABOUT NEGLIGENCE

Litwin v. Allen is the first modern case in which a court held directors liable simply for negligent management.⁷ This, by itself, gave the case major importance. That it involved famous and prestigious banking houses, and unusual facts, helped insure *Litwin's* place in history. To set the stage for further analysis, it is necessary to tell the story of *Litwin*.

It all began in early 1929, just before the start of the Great Depression, when clients of J. P. Morgan & Co. organized Alleghany Corporation to invest in railroad securities.⁸ By October of the next year the depression was one year old, and Alleghany needed \$10 million to pay for railroad terminals in Kansas City and St. Joseph, Missouri. Because of a borrowing limitation in its charter, a loan was not possible,⁹ but Morgan came to the rescue by agreeing to transactions designed to substitute for a loan.¹⁰ What Morgan did was purchase from Alleghany \$10 million face amount of debentures issued by Alleghany's subsidiary, Missouri Pacific Railroad. Because the debentures were convertible into Missouri Pacific common stock, and because Alleghany did not want this stock to fall into the hands of outsiders, Alleghany retained the option to repurchase the debentures, at the price paid by Morgan, within six months.¹¹ Since Morgan would receive the interest accrued on the debentures during the time it owned them, the sale and repurchase would have essentially the financial attributes of a loan, but without violating Alleghany's charter.

The road to *Litwin v. Allen* began when Morgan sold a \$3 million participation in the transactions to its affiliate, Guaranty

7 There are, of course, earlier cases that provide insight on the subject. See, e.g., *Bates v. Dresser*, 251 U.S. 524 (1920); *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924); *Hun v. Cary*, 82 N.Y. 65 (1880).

8 25 N.Y.S.2d at 679.

9 *Id.* at 691.

10 *Id.* at 696.

11 *Id.* at 692.

Trust Company of New York,¹² upon the approval of the Trust Company's directors.¹³ Next, of course, the depression deepened, the market value of the Missouri Pacific debentures fell precipitously, and Alleghany never exercised its option.¹⁴ Trust Company shareholders then sued the directors for negligence in approving the Trust Company's participation in the Alleghany transactions. The court's discussion of what it called "the rules to be applied in determining the liability of directors"¹⁵ was brief: "directors are liable for negligence in the performance of their duties In the last analysis, whether or not a director . . . has been negligent, depends on the facts and circumstances of a particular case A director is called upon 'to bestow the care and skill' which the situation demands."¹⁶

Turning to the Alleghany situation, the court found that the "directors plainly failed . . . to bestow the care which the situation demanded."¹⁷ The judge said, "I find liability in this transaction because the entire arrangement was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice."¹⁸ Then the court asked an intriguing question: "What sound reason is there for a bank . . . to buy securities under an arrangement whereby any appreciation will inure to the benefit of the seller and any loss will be borne by the bank?"¹⁹ Plainly, there was no *sound* reason for the directors to have approved the arrangement. The defects were clear in hindsight, and the arrangement cost the Trust Company \$1,000,000.²⁰ Why, then did the directors approve it? An examination of this question and its importance is included in Part IV of this Article, which discusses proposed bases for directors' negligence liability.

Although *Litwin* clearly established a precedent for holding directors liable for negligence, few cases were decided against them after *Litwin*.²¹ Directors soon fell into a state of comfort-

12 *Id.* at 693.

13 *Id.* at 702.

14 *Id.* at 695.

15 *Id.* at 677.

16 *Id.* at 678 (quoting *New York Cent. R.R. v. Lockwood*, 17 Wall. 357, 382-83 (1873)).

17 *Id.* at 699.

18 *Id.*

19 *Id.*

20 *N.Y. Times*, Dec. 19, 1940, at 39, col. 4.

21 Joseph Bishop commented in 1968: "The hard fact is that cases in which direc-

able complacency. As the British life peer, Lord Boothby, put it:

If you have five directorships it is total heaven, like having a permanent hot bath No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company, you look grave and sage, on two occasions say, "I agree," say "I don't think so" once, and if all goes well you get 500 pounds a year.²²

This continued until the late 1960s. The turning point was the decision in *Escott v. BarChris Construction Corp.*,²³ a case under section 11 of the Securities Act of 1933²⁴ in which directors were held liable for defects in their corporation's registration statement.²⁵ After *BarChris*, Boothby's "hot bath" took on new meaning for directors as they became more and more concerned about what courts expected of them and what they could do to protect themselves from negligence claims.

Although *BarChris* served to raise the consciousness of directors, it did not provide any guidance about what is or is not negligence for directors, because it involved the application of a narrow statutory criterion of behavior²⁶ rather than a general negligence standard. The major directors' negligence cases of the 1970s and early 1980s, *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*²⁷ and *Francis v. United Jersey Bank*,²⁸ did provide helpful general guidance by emphasizing the directors' monitoring or supervisory role within the corporation.²⁹ But neither case provided a meaningful analysis of

tors of business corporations are held liable, at the suit of stockholders, for mere negligence are few and far between." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095 (1968).

22 Chamberlain, *Why it's Harder and Harder to Get a Good Board*, FORTUNE, Nov. 1962, at 109.

23 283 F. Supp. 643 (S.D.N.Y. 1968).

24 15 U.S.C. § 77k (1988).

25 Writing in the early 1970s, with the benefit of the right amount of hindsight, Robert Estes indicated that *BarChris* "is credited with marking a new era in the law governing director liabilities." Estes, *Outside Directors: More Vulnerable than Ever*, HARV. BUS. REV. 109 (Jan.-Feb. 1973).

26 The criterion is one of "reasonable investigation" before a director can take advantage of the general "due diligence" defense provided by section 11(b) of the Securities Act of 1933. 15 U.S.C. § 77k(b) (1988).

27 381 F. Supp. 1003 (D.D.C. 1974).

28 87 N.J. 15, 432 A.2d 814 (1981).

29 See e.g., *Lucy Webb Hayes*, 381 F. Supp. at 1014 ("A director whose failure to supervise permits negligent mismanagement by others to go unchecked has committed an independent wrong against the corporation"); *Francis*, 87 N.J. at 32, 432 A.2d at 822 ("Directorial management does not require a detailed inspection of day-to-day activities,

directors' conduct against a negligence standard because the directors either did nothing, as in the case of *Francis*,³⁰ or next to nothing relevant to the facts at hand, as in *Lucy Webb Hayes*.³¹

*Smith v. Van Gorkom*³² is the most important directors' liability case since *Litwin*.³³ Like *Litwin*, it involved alleged mismanagement by directors in connection with their approval of a proposed corporate transaction. The transaction was a merger in which the shareholders of Trans Union Corporation would receive \$55 per share.³⁴ The merger had been negotiated by the chief executive officer of Trans Union without the knowledge of the board, and was approved at a board meeting after two hours of consideration.³⁵ Without any substantial discussion of the standard against which the directors' conduct was to be judged,³⁶ the Delaware Supreme Court determined that the directors had failed adequately to inform themselves about various matters, including the intrinsic value of the corporation.³⁷ The court stated that the directors were, at a minimum, grossly negligent in approving the merger.³⁸ As a result, the court held the directors liable for the difference between what the shareholders received in the merger and the fair value of the corporation, which value was to be determined at an evidentiary hearing.³⁹ At this point,

but rather a general monitoring of corporate affairs and policies.”).

30 “[The defendant-director] did not pay any attention to her duties as a director or to the affairs of the corporation.” 87 N.J. at 27, 432 A.2d at 819.

31 “In short, these [directors] have . . . failed to exercise even the most cursory supervision over the handling of Hospital funds and failed to establish and carry out a defined policy.” 381 F. Supp. at 1016.

32 488 A.2d 858 (Del. 1985).

33 As an example of *Van Gorkom*'s influence, it appears that all or virtually all corporation law casebooks published since *Van Gorkom* have included this case. See W. CARY & M. EISENBERG, CORPORATIONS: CASES AND MATERIALS 519 (6th ed. Supp. 1988); J. CHOPER, J. COFFEE & C. MORRIS, CASES AND MATERIALS ON CORPORATIONS 247 (3d ed. 1989); A. CONARD, R. KNAUSS & S. SIEGEL, ENTERPRISE ORGANIZATION 692 (4th ed. 1987); H. HENN, CORPORATIONS: CASES AND MATERIALS 401 (2d ed. 1986); R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 704 (4th ed. 1990); L. SODERQUIST & A. SOMMER, CORPORATIONS: A PROBLEM APPROACH 215 (2d ed. 1986); L. SOLOMON, D. SCHWARTZ & J. BAUMAN, CORPORATIONS: LAW AND POLICY 623 (2d ed. 1989); D. VAGTS, BASIC CORPORATION LAW 212 (3d ed. 1989).

34 *Van Gorkom*, 488 A.2d at 867.

35 *Id.* at 865-69.

36 *See id.* at 872-73.

37 *Id.* at 874.

38 *Id.*

39 *Id.* at 893. The directors pleaded the business judgment rule, which in Delaware protects directors by establishing “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Id.* at 872 (quot-

the plaintiffs' lawyers were projecting damages of up to \$200 million, with the directors having only an estimated \$20 million in liability insurance.⁴⁰ Ultimately, the case was settled for \$23.5 million,⁴¹ without an evidentiary hearing having been held. But \$23.5 million was sufficient to keep the fears of directors from abating.

The president of the National Association of Corporate Directors has said that *Van Gorkom* "created perilous times for corporate directors,"⁴² and has called the decision "the straw that broke the camel's back" as far as directors are concerned.⁴³ Clearly the case had the direct effect of frightening directors. In an article discussing the fallout of the decision, for example, a business school dean who is a director of eight corporations was quoted as saying: "I would probably resign from every board on which I serve if I am liable beyond my directors' and officers' insurance."⁴⁴ Regrettably, for this and other directors, *Van Gorkom* also had the indirect effect of making directors' liability insurance harder to get and substantially more expensive.⁴⁵ By mid-1986, a directorship was in danger of becoming what one business writer called "a job that nobody wants."⁴⁶

ing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Super. Ct. 1984)). Here the rule did not protect the directors because, in the view of the court, the rule offers "no protection to directors who have made 'an unintelligent or unadvised judgment,'" *id.* at 872 (quoting *Mitchell v. Highland-Western Glass*, 167 A. 831, 833 (Del. Ch. 1933)), and because in Delaware a finding of gross negligence answers in the negative the question of whether a decision is an informed one. *Id.* at 873.

40 Glaberson & Powell, *A Landmark Ruling that Puts Board Members in Peril*, BUS. WK., Mar. 18, 1985, at 56, 57.

41 Mauro, *Liability in the Boardroom*, NATION'S BUS., May 1986, at 46.

42 Glaberson & Powell, *supra* note 40, at 56.

43 Mauro, *supra* note 41, at 45-46.

44 Presumably meaning he would resign if his personal wealth were greater than the policy limits. Glaberson & Powell, *supra* note 40, at 57. See also, e.g., Mauro, *supra* note 41, at 46.

45 Shortly after *Van Gorkom*, a manager of the leading directors' liability insurer, Lloyd's of London, said, "Any buyer who thinks the cost of his insurance will only double is a dreamer." Newport, *Protecting Directors Suddenly Gets Costly*, FORTUNE, Mar. 18, 1985, at 61. Two years after *Van Gorkom*, Korn/Ferry International estimated that the premiums for directors' liability insurance "went up more than 900 percent in just two years." Powell, *Is It Safe to Go Back in the Boardroom?*, NEWSWEEK, May 4, 1987, at 45, 46.

46 Baum, *The Job Nobody Wants*, BUS. WK. Sept. 8, 1986 at 56.

III. RESPONSE OF STATE LEGISLATURES

In June of 1986 the Delaware legislature stepped in. Its response to what some were now calling a "crisis,"⁴⁷ was this amendment to the Delaware General Corporation Law: "[T]he certificate of incorporation may . . . contain . . . [a] provision eliminating or limiting the personal liability of a director to the corporation for monetary damages for breach of fiduciary duty as a director [except] for acts or omissions not in good faith"⁴⁸ Delaware corporations rushed to amend their certificates of incorporation, and a sizable number of out-of-state corporations reincorporated in Delaware to take advantage of the new provision.⁴⁹ In a characteristic phenomenon well described by William L. Cary,⁵⁰ other states quickly began adopting copies or near copies of the Delaware amendment. Almost two-thirds of the states have now done so.⁵¹

Legislatures in the remaining states now must decide if they also are going to follow Delaware's lead. In those states that have adopted one of the new provisions, it will be the job of the courts to interpret them. At the same time, it will continue to be

47 See, e.g., Powell, *supra* note 45, at 46.

48 See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988). The "except" clause also included acts and omissions constituting the unlawful declaration of dividends, intentional misconduct, a knowing violation of law or a breach of the director's duty of loyalty. These are derelictions generally involving something other than ordinary negligence, and they have not been involved in the directors' liability "crisis."

49 See, e.g., Powell, *supra* note 45, at 45.

50 Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 665-66 (1974).

51 ALASKA STAT. § 10.06.210 (1989); ARIZ. REV. STAT. ANN. § 10-054 (1990); ARK. STAT. ANN. § 4-27-202 (1990); CAL. CORP. CODE § 204 (West Supp. 1990); GA. CODE ANN. § 14-2-202 (1989); COLO. REV. STAT. ANN. § 7-3-101 (West 1990); HAW. REV. STAT. ANN. § 415-48.5 (Michie Supp. 1990); IDAHO CODE § 30-1-54 (Supp. 1990); IOWA CODE ANN. § 491.5 (West Supp. 1990); KAN. STAT. ANN. § 17-6002 (1988); KY. REV. STAT. ANN. § 271A.271 (Baldwin 1989); LA. REV. STAT. ANN. § 12:24 (West Supp. 1990); MD. CORPS. & ASS'NS CODE ANN. ch. 546 § 2-405.2 (1990); MASS. GEN. LAWS ANN. ch. 156B § 13 (Law. Co-op. 1990); MICH. COMP. LAWS ANN. § 450.1209 (West 1990); MINN. STAT. § 300.64 (1989); MONT. CODE ANN. § 35-1-202 (1989); NEV. REV. STAT. ANN. § 78.037 (Michie Supp. 1989); N.H. REV. STAT. ANN. § 293-A:54 (Supp. 1989); N.J. STAT. ANN. § 14A: 2-7 (West Supp. 1990); N.Y. BUS. CORP. LAW § 402 (McKinney Supp. 1990); N.C. GEN. STAT. § 55-2-02 (1990); OKLA. STAT. ANN. tit. 18 § 1006 (West Supp. 1990); ORE. REV. STAT. ANN. § 60.047 (Butterworth Supp. 1990); 42 PA. CONS. STAT. ANN. § 8364 (Purdon Supp. 1990); R.I. GEN. LAWS § 7-1.1-48 (Supp. 1989); S.D. CODIFIED LAWS ANN. § 47-2-58.8 (Supp. 1990); TENN. CODE ANN. § 48-12-102 (1988); TEX. REV. CIV. STAT. ANN. § 1302-7.06 (Vernon Supp. 1990); UTAH CODE ANN. § 16-10-49.1 (Supp. 1990); WASH. REV. CODE ANN. § 23A.12.020 (Supp. 1990); WYO. STAT. § 17-16-834 (1989).

the task of courts to render decisions about directors' negligence liability without reference to one of these provisions.⁵² In each of these situations, it would be helpful for the legislature or court to have available theoretical and experiential bases for directors' negligence liability when exercising the judgments required of them.

IV. THEORETICAL AND EXPERIENTIAL BASES FOR DIRECTORS' NEGLIGENCE LIABILITY

The proper bases for making judgments about directors' negligence liability need to be both theoretical and experiential. This is shorthand for saying that in making these judgments, courts and legislatures should have in mind just what they are trying to accomplish (the theoretical base), and should also have some sound means of evaluating whether a particular decision is likely to help or hinder what they are trying to accomplish (the experiential base).

A. *Theoretical Base*

Directors should be held liable for arguably negligent conduct when doing so satisfies some desired end. It is a thesis of this Article that there are three such ends. First, an arguably negligent director should be held liable when that director is blameworthy and when a finding of liability will help channel the future behavior of directors in a desired way. This might involve deterrence, but more often it would involve pushing directors toward particular conduct rather than merely attempting to dissuade them from repeating a defendant-director's past actions. For example, the decision in *Van Gorkom* can be read as encouraging directors to hire investment bankers to value their corporation before approving its sale.⁵³

The second desired end in holding an arguably negligent director liable is recompensing the corporation or its shareholders, or some other appropriate client-group,⁵⁴ for an injury at-

52 Some of these courts will sit in states still using only a common law formulation for determining directors' liability, and others will decide cases involving directors of corporations that do not specify the good faith standard in their corporate charter.

53 Dicta, of course, is a typical way that courts effect this positive channeling. But often, as in the *Van Gorkom* situation, the inclusion of channeling dicta is not necessary.

54 For a discussion of directors' responsibility to groups other than the shareholders, see Soderquist & Vecchio, *Reconciling Shareholder Rights and Corporate Responsibility: New Guidelines for Management*, 1978 DUKE L.J. 819.

tributable to conduct for which the director is blameworthy. The important focus here is on blameworthiness. Before deciding that recompense from a director is appropriate, it is important to determine if there was an injury to someone having a claim on the director, and if the injury is attributable to the director. Decisions on these matters are typical of everyday decisionmaking by judges. Determining blameworthiness of directors, however, is a more specialized and difficult matter. This will be discussed further below.

The third desired end in holding liable an arguably negligent director is to punish the director for blameworthy conduct. Some might argue that punishment is an inappropriate goal for a theory of negligence liability. Certainly criminal law holds society's main store of retribution. But punitive damages are well established in tort law. Also, punishment, in terms of a money judgment and its attendant blight on reputation, seems appropriate for a director who has taken a large stipend from the corporation⁵⁵ while in a prestigious position,⁵⁶ but who by engaging in blameworthy conduct has failed to keep faith with the corporation.

Finally, to these ends a caveat must be added: The application of judicial decisionmaking in their pursuit must not be so rigorous as to deter a sufficient number of qualified candidates from serving as directors, nor to make the costs involved in attracting such candidates unreasonably high.⁵⁷

B. *Experiential Base*

Two critical questions arise from the above discussion and need to be answered before decisions can be made about whether a director should be held liable for arguably negligent conduct. First, "Is the director blameworthy?" and second, "Will holding the director liable help channel the future behavior of directors in a desired way?" Courts tend to answer such questions by reference to their own intuition. This can have unfortunate consequences, because in matters such as those involved here, intuition often is not a reliable guide. *Litwin v. Allen* provides a good example.

55 See, e.g., Baum, "Professional" Directors: So Many Boards, So Little Time, BUS. WK. SEPT. 8, 1986, at 59. But see Dunn, Directors Aren't Doing Their Jobs, FORTUNE, Mar. 16, 1987, at 117.

56 E.g., *The Art of Landing a Boardroom Seat*, BUS. WK., Dec. 22, 1986, at 71.

57 The costs mainly would involve the promised direct and indirect compensation and payment for the corporation's officers' and directors' liability insurance.

As indicated above,⁵⁸ the interesting question about *Litwin* is why the directors of the Trust Company approved an arrangement whereby any appreciation in the value of the Missouri Pacific debentures it purchased from Alleghany would inure to the benefit of Alleghany and any loss would be borne by the Trust Company. One writer has suggested that "the answer lay in the complex interdependencies of high finance in those troubled times."⁵⁹ The problem with this theory is that the finance involved was very basic. As any first year business school student can appreciate, with Alleghany having a call,⁶⁰ the Trust Company needed a put.⁶¹ This is so obvious that, if the Trust Company had requested a put, Alleghany could not have refused.

The question then is, why did the directors not demand a put? Two obvious possibilities come to mind: incompetence and double-dealing. But it is almost inconceivable that directors of a major bank were in over their heads at so basic a level of finance, and the court took pains to dispel any suspicions of dishonesty.⁶² Further, contemporary newspaper accounts hint at neither incompetence nor dishonesty.⁶³ The most likely remaining possibility is that the directors did not "see" the defect in the Alleghany arrangements when the arrangements were presented to them for approval. That is, the directors heard a description of the arrangements and an explanation of what the arrangements were designed to accomplish,⁶⁴ determined that the arrangements made good business sense in the context presented, and approved the arrangements without it having crossed their minds that the arrangements contained a monumental defect.

If the directors did not "see" the defect, it is probable that some phenomenon of human behavior was behind this failure. If this is the case, an understanding of this phenomenon would be helpful in making decisions both about blameworthiness and about how to channel directors' conduct. The literature of psycho-

58 See *supra* text accompanying notes 19-20.

59 Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 370 (1965).

60 A "call" is a right to buy securities on terms agreed to in advance.

61 A "put" is a right to sell securities on terms agreed to in advance.

62 *Litwin*, 25 N.Y.S.2d at 699 ("[T]he honesty of the directors in this case is unquestioned.")

63 See, N.Y. Times, May 21, 1940, at 39, col. 6; May 28, 1940, at 35, col. 8; Dec. 19, 1940, at 39, col.4.

64 Actually, some directors heard the description and explanation twice, because the arrangements were approved first at a meeting of the executive committee and later at a meeting of the full board. *Litwin*, 25 N.Y.S.2d at 702.

logical experimentation suggests two possibilities. One is the phenomenon of set, the other a phenomenon called functional fixedness.

In the context of problem solving, "set" means a "tendency . . . to respond to subsequent stimuli on the basis of preceding stimuli."⁶⁵ This tendency may manifest itself as behavioral rigidity, which is "a lack of shift in behavior when the situation calls for a shift."⁶⁶ The classic experiments are Luchins' water jar problems.⁶⁷ In these experiments, Luchins presented to subjects a series of problems along these lines: "Given: an empty 21-quart jar, an empty 127-quart jar, and an empty 3-quart jar; measure 100 quarts of water."⁶⁸ If the jars are referred to in order as A, B and C, the solution may be expressed as the formula B minus A minus 2C. After giving subjects a series of problems solvable only using this formula, Luchins introduced another series.⁶⁹ All of the problems in this series, except one, could be solved this same way, but they could also be solved by a direct and simple formula, such as A minus C. One problem in this series could be solved only by the A minus C formula.⁷⁰ Finally, Luchins gave to a control group only the second series of problems, skipping the earlier series. The object of the experiments was to determine if the first series of problems induced mental set in the subjects, which Luchins called "Einstellung."⁷¹ This would be indicated by the subjects solving problems in the second series of problems by the round-about means learned in solving the first series, and by the inability of the subjects to solve the one problem that could

65 Kearsley, *Problem-Solving Set and Functional Fixedness: A Contextual Hypothesis*, 16 CAN. PSYCHOLOGICAL REV. 261, 262 (1975).

66 Luchins, *The Einstellung Test of Rigidity: Its Relation to Concreteness of Thinking*, 15 J. CONSULTING PSYCHOLOGY 303, 308 (1951).

67 For the earliest and most comprehensive report of these experiments, see Luchins, *Mechanization in Problem-Solving*, 54 PSYCHOLOGICAL MONOGRAPHS No. 6 (1942). For a more concise exposition, see Luchins, *On the Recent Usage of the Einstellung-Effect as a Test of Rigidity*, 15 J. CONSULTING PSYCHOLOGY 89 (1951).

68 Luchins, *On the Recent Usage of the Einstellung-Effect as a Test of Rigidity*, *supra* note 67, at 89.

69 There was no break point by which subjects could identify the end of the first series and the beginning of the second.

70 Some subjects were simply given the problems and told to solve them. Others were told to write on their papers, just before the second series of problems, "Don't be blind."

71 Luchins indicated that Einstellung is "the set which immediately predisposes an organism to one type of motor or conscious act." Luchins, *Mechanization in Problem-Solving*, *supra* note 67, at 3 n.4 (citing H. WARREN, *DICTIONARY OF PSYCHOLOGY* 371 (1934)).

only be solved by using the direct and simple formula.

Luchins reported that "[l]arge Einstellung effects were obtained in all experimental groups, whether they were composed of elementary school children, high school children, college students, adults with no formal education, or college professors."⁷² For example, in six groups of college students, from 70 to 100 percent of the subjects exhibited the set phenomenon.⁷³ Perhaps most interesting were the results achieved by these groups on the one question that could be solved only by application of the direct and simple formula. In the best performing of these groups, 27 percent of the subjects could not solve this problem in the allotted two-and-one-half minutes. In the other five of these groups, from 50 to 70 percent of the subjects failed to solve this problem.⁷⁴ No subject in a college student control group (to whom only the second series of problems was presented) failed to solve any of the problems, including the problem that could be solved only by the direct and simple formula, and for each problem all of these control subjects used the direct and simple formula rather than the roundabout one.⁷⁵ Typical responses of non-control subjects after being shown the direct and simple formula were: "How dumb I was," "How stupid of me," "How blind I was."⁷⁶

The second phenomenon to be examined, functional fixedness, is the phenomenon that "[k]nowledge of the usual use or function of an object leads to a 'fixation' of that object to a specific purpose."⁷⁷ Of the classic experiments on functional fixedness, the most famous is Duncker's box problem.⁷⁸ In this problem Duncker led a subject to a table on which he had placed, among some extraneous objects, three small boxes, along with some matches, tacks and candles. In one variation of the experi-

⁷² Luchins, *On Recent Usage of the Einstellung Effect as a Test of Rigidity*, *supra* note 67, at 90. Luchins found no statistically significant variation among the subjects he grouped by I.Q. Luchins, *Mechanization in Problem-Solving*, *supra* note 67, at 19.

⁷³ Luchins, *Mechanization in Problem-Solving*, *supra* note 67, at 6. Groups of subjects who received the "Don't be blind" warning, *see supra* note 70, solved the immediately following problems by application of the direct and simple formula from 7% to 50% more frequently than did those who had not received the warning. Luchins, *Mechanization in Problem-Solving*, *supra*, note 67, at 7.

⁷⁴ *Id.* at 14-15.

⁷⁵ *Id.* at 6-7, 15.

⁷⁶ *Id.* at 2.

⁷⁷ Kearsley, *supra* note 65, at 263.

⁷⁸ *See* Duncker, *On Problem-Solving*, 58 PSYCHOLOGY MONOGRAPH No. 5 at 85-88 (1945).

ment, the matches, tacks and candles were in the three boxes, in the other variation the boxes were empty. Duncker told the subject that his task was to find a way to place three candles on the door, at the height of the eyes. When the boxes were presented empty, 100 percent of the subjects solved the problem by attaching a box to the door with tacks and using the box as a platform for the candles. When the boxes were filled with the other objects, only 42.9 percent of the subjects solved the problem.⁷⁹ The rest of the subjects seemed to fixate on the use of the boxes as containers. As in the case of the water jar experiments, a phenomenon of human behavior prevented subjects from "seeing" what in other circumstances was an obvious solution to a relatively simple problem.

Set and functional fixedness are so similar that psychologists generally believe that they are variations of the same basic phenomenon.⁸⁰ If it is correct that the Trust Company directors in *Litwin* approved the Alleghany transactions because they did not "see" the latent defect in these transactions, it seems probable that this failure to "see" arose as a result of the basic behavioral phenomenon of which set and functional fixedness are apparently variants.⁸¹ Specifically, the directors may have had a mental predisposition toward viewing the Alleghany transactions merely as a creative substitute for a loan, and thus failed to perceive the defect that is so apparent when the terms of the transactions are viewed in a straightforward financial context. Alternatively, the directors may have fixated on the role of the debentures as tools by which Alleghany could maintain control of Missouri Pacific, and thus failed to consider that no contract existed under which the debentures must be repurchased. One can visualize the Trust Company directors saying, with a self-inflicted slap to the forehead, the same things as Luchins' subjects: "How dumb I was," "How stupid of me," "How blind I was."

If these suppositions are correct, were the Trust Company directors blameworthy? Or, put another way, was it fair to take

79 *Id.* at 86, 88.

80 Kearsley, *supra* note 65, at 261. See also, Flavell, Cooper & Loisselle, *Effect of the Number of Pre-Utilization Functions on Functional Fixedness in Problem Solving*, 4 PSYCHOLOGY REP. 343, 343 (1958).

81 A search of the psychological literature failed to disclose another phenomenon likely to explain the directors' behavior. If some phenomenon of human behavior was behind the directors' failure to "see" the latent defect, it is unlikely that the phenomenon is one that has escaped the notice of experimental psychologists.

money out of their pockets and give it to the Trust Company? And was it fair to take the directors' reputations in the process? The directors were not blameworthy if their behavior arose as a consequence of blindness induced by normal mental processes they did not control, rather than from a lack of interest or effort. The reputation of the directors should not have been damaged by such conduct, and the corporation rather than the directors should have borne the financial consequences of the directors' acts. Directors should not be held liable for failing to conform their conduct to a standard established without reference to the realities of human behavior.

Blameworthiness, however, is only one of the postulated criteria for holding liable an arguably negligent director. The other criterion is whether holding the director liable will help channel the future behavior of directors in a desired way. Again focusing on the *Litwin* situation as a paradigm, the literature of psychological experimentation will help answer whether this criterion was met in that case. If it was, any beneficial channeling of behavior presumably came about because of the directors' concern that they might be held liable if their performance did not meet a court's expectations. In psychological terms, a product of this concern was stress. This being the case, it is necessary to determine the likely effect of stress on directors' performance.

Studies on the effects of stress on various tasks have tended to classify the tasks as relating either to verbal or perceptual-motor performance.⁸² In each area of performance, experimental studies long ago have shown deleterious effects resulting from psychological stress. In the verbal area, for example, fifty-year-old research showed that stress causes a decrease in both rate of learning⁸³ and in recall.⁸⁴ In the area of perceptual-motor performance, experiments now four decades old showed such effects as increased rigidity and non-adaptive behavior.⁸⁵ For present purposes, the most interesting study is one involving psychological stress applied to subjects solving Luchins' water jar problems.⁸⁶

82 Lazarus, Deese & Osler, *The Effects of Psychological Stress Upon Performance*, 49 PSYCHOLOGY BULL. 293, 301 (1952).

83 Thorndike & Woodyard, *The Influence of the Relative Frequency of Successes and Frustrations Upon Intellectual Achievement*, 25 J. EDUC. PSYCHOLOGY 241, 249-50 (1934).

84 Zeller, *An Experimental Analogue of Repression: II. The Effect of Individual Failure and Success on Memory Measured by Relearning*, 40 J. EXPERIMENTAL PSYCHOLOGY 411 (1950).

85 Marquart, *The Pattern of Punishment and its Relation to Abnormal Fixation in Human Subjects*, 39 J. GEN. PSYCHOLOGY 107 (1948).

86 Cowen, *The Influence of Varying Degrees of Psychological Stress on Problem-Solving*

Here the experimenter separated his subjects into three groups: a control group to which he gave the problems without stress, a mildly stressed group⁸⁷ and a strongly stressed group.⁸⁸ The number of roundabout rather than direct and simple solutions to the problems doubled between the control and mildly stressed groups and doubled again for the strongly stressed group,⁸⁹ indicating "that problem-solving rigidity increases under increasing degrees of psychological stress."⁹⁰

Considering the negative effects of stress, it is unlikely that *Litwin* has helped channel other directors' problem solving behavior in desirable ways. To the contrary, any effect on other directors in this respect probably has been deleterious. Fear of liability engendered by *Litwin* may have prompted directors to attend meetings more regularly, read corporate reports with greater care, or pay more attention to other duties. But, even if so, this effect came at the cost of holding non-blameworthy directors liable.

V. CONCLUSIONS

Directors are not supposed to be insurers of the wisdom of their decisions.⁹¹ Nevertheless, this is what too easily happens when, as in *Litwin*, the focus of a court's inquiry is the substance of a director's decision. The intuition of courts about blameworthiness, and about the channeling of future conduct, is not a reliable guide when this is a court's focus. For a court to draw rational conclusions based on the substance of decisions, it would have to base its decision on scientific evidence rather than on its

Rigidity, 47 J. ABNORMAL SOC. PSYCHOLOGY 512 (1952).

87 Near the beginning of the water jar problems, the experimenter introduced a new problem designed to induce mild stress. The problem was an intriguing mental puzzle that, while engaging the subjects' interest, was not solvable as a practical matter. *Id.* at 513.

88 The experimenter induced strong stress mainly in this way: First, he had all subjects take a psychological test, telling them that the results of the test would be reviewed by a board of clinicians and that those "whose records were questionable would probably be called back for additional testing." Some days later the experimenter told a quarter of the group, chosen at random, that their tests "had pointed to the presence of certain maladaptive personality features, and that the purpose of the testing about to take place was to provide further data to test the accuracy of the diagnostic formulation." The experimenter then gave the subjects the water jar problems. (In a debriefing at the end of the experiment, the experimenter told the subjects about the random nature of their selection.) *Id.* at 513-14.

89 *Id.* at 515 (table 2).

90 *Id.* at 518.

91 See, e.g., *Litwin*, 25 N.Y.S.2d at 678; *Selheimer v. Manganese Corp.*, 423 Pa. 563, 581, 224 A.2d 634, 644 (1966).

own intuition. This is not a happy prospect, for the science involved is inexact, and its proof would turn on the conflicting testimony of experts. Among other problems, directors could not predict with any accuracy what conduct might later be considered negligent. The alternative is for courts to focus only on the process of decisionmaking when determining the question of a director's negligence. Refinements will be discussed below,⁹² but basically the best question to ask would be: Did the director try to do an adequate job? This is an inquiry that is both directed precisely at blameworthiness and is well suited to judicial decisionmaking.⁹³

Considering the recent statutory amendments on the question of directors' liability,⁹⁴ it is important to determine whether these amendments establish the proper standard for liability. If they do, legislatures that have not yet adopted such an amendment should do so, and courts should adopt the standard established by these amendments when the choice of standard is theirs. These amendments allow a corporation to eliminate the liability of a director for breach of fiduciary duty, insofar as negligence liability is concerned, except for acts or omissions that were not in good faith.⁹⁵

In evaluating this standard, it is necessary to determine what "good faith" means in this context. "Good faith" is used in a wide variety of legal contexts, and it means different things in different contexts, with large cross-contextual variations.⁹⁶ Certainly the term always includes something like "pureheartedness." Just as certainly it means more than simply this in the context of the directors' negligence standard. In determining the meaning of "good faith" in this context, it will be helpful first to focus on the fact that corporation statutes give a number of responsibilities to

92 See *infra* text preceding note 100.

93 As was apparent in the *Van Gorkom* situation, the business judgment rule has been only a half-way measure in protecting directors against the unreasonable imposition of liability based on the substance of their decisions. As the directors found in that case, see *supra* note 39, and as they would likely find in a case replicating the *Litwin* situation, courts have substantial leeway in deciding whether or not to override the presumptions in a director's favor that are established by the rule. A large part of the problem, of course, is that a court can override such a presumption when it believes a director's judgment was "unintelligent or unadvised." See *id.*

94 See *supra* text accompanying notes 47-51.

95 See *id.*

96 For a broad treatment of the term "good faith" as used in various contexts, see 18A WORDS AND PHRASES 83-131 (1956 & Supp. 1990). Examples of the use of the term are collected under 84 separate headings.

directors,⁹⁷ and that a director cannot ignore these responsibilities without being intentionally derelict. Whatever else "good faith" may encompass, it does not include intentional dereliction. These two concepts are quite clearly mutually exclusive. As a starting point, therefore, one can say that to be in good faith, a director necessarily must engage in conduct aimed at discharging his or her responsibilities.⁹⁸

This being the case, the next step is to determine what is required for a director's *conduct* to be in good faith. "Good faith" is inherently a subjective quality of the person acting or omitting to act rather than an objective description of the person's act or omission. Two points follow from this observation. First, the good faith standard for directors' conduct must be a standard that relates to the conduct itself rather than to the results of the conduct. Second, the standard must be one that is capable of being met solely by the existence of a particular state of the director's mind concerning the conduct.⁹⁹

The parameters thus established for the good faith standard for directors' conduct also come close to defining the standard, because any drafter working within these parameters must necessarily arrive at a formulation of the standard along these lines: Conduct is in good faith if the director reasonably believes such conduct is sufficiently adequate to discharge his responsibilities as a director.

One point about which there may be contention is the requirement of reasonableness of belief. It might be argued that belief as to adequacy of conduct by itself should establish good faith, no matter how unreasonable the belief. But it must be remembered that something like "pureheartedness" is an element of good faith, and this element finds its way into the above formulation of the good faith standard through the criterion of reasonableness, which here can be taken as a manifestation of pureheartedness. While it is true that a completely empty-headed director could hold any sort of belief with a pure heart, other directors cannot be purehearted without attempting to determine what it takes for them adequately to discharge their responsibilities. "Reasonably believes" is used here to indicate belief reached

97 See, e.g., Soderquist, *supra* note 3, at 1342-43.

98 The conduct could, of course, be the act of deciding to do nothing in a given situation.

99 This does not mean that the existence of a subjective state of mind cannot be determined by objective manifestations.

after making an attempt, which the director believes to be sufficient, to determine what conduct is necessary to discharge his or her responsibilities adequately.¹⁰⁰

The question of whether good faith is the proper standard for directors' negligence liability can now be answered. In a summary of the discussion above,¹⁰¹ it can be stated that the proper standard is one that will result in liability for an arguably negligent director when one or more of the following ends thereby will be served: (1) the future behavior of directors will be channeled in a desired way by holding liable a blameworthy director; (2) the corporation or its shareholders, or some other client group, will be recompensed for an injury attributable to conduct for which the director is blameworthy; or (3) punishment will accrue to a blameworthy director.

The good faith standard is an ideal standard largely because of its clear focus on blameworthiness. Part of the standard's virtue in this regard flows directly from its substance, its essence of "pureheartedness."¹⁰² Part also derives from the fact that "good faith" is a subjective quality of persons rather than an objective description of their acts.¹⁰³ Also, as indicated above,¹⁰⁴ the subjective nature of the standard mandates a focus on the conduct of directors—that is, on the process of their decision-making—rather than on the results of their conduct. This focus will guide courts away from decisions, such as that reached in *Litwin*, that are based on the courts' own untrustworthy intuitions about the substance of a director's actions, and that lead to the imposition of liability on a director who is not blameworthy.¹⁰⁵

The application of the good faith standard will also channel the future conduct of directors in desired ways. Channeling of behavior is a practical exercise. To be effective, a legislature or court needs to send a simple, unequivocal message. In the case of directors, the desired message has always been, and under the

100 Actual proof of the elements of "reasonableness" would be unavoidable if a director's conduct was not congruent with real-world norms. Otherwise, to avoid the uncertainties inherent in ad hoc judicial examinations of subjective states of mind, courts could apply the following presumption: Conduct will be rebuttably presumed to meet the good faith standard if it conforms to that of the average director in analogous circumstances.

101 See *supra* text accompanying notes 53-55.

102 See *supra* text following note 96.

103 See *supra* text following note 98.

104 *Id.*

105 See *supra* text accompanying notes 58-81.

good faith standard remains, something like this: Make a reasonable effort to be a good director or you will be held liable for the damages you cause. But, until the adoption of the good faith standard, that was not the message sent. Too often the message was: Make good decisions or you may be held liable. The good faith standard is clean enough, and its message is plain enough, that finally the right message may get through to directors.

