

BREACH OF FIDUCIARY DUTY AND THE DEFENSE OF RELIANCE ON EXPERTS

Douglas Moll*

The topic that I would like to discuss with you today is “Breach of Fiduciary Duty and the Defense of Reliance on Experts.”¹ When you all were kind enough to invite me last year, I had a finished draft and it was very easy to present. This year, I am on the opposite end of the article life cycle. This is really more of a collection of ideas at this point. I am at a very, very early stage and I am not even sure what direction this is going to go, so I look forward to your comments. I am going to raise some questions this morning without really answering them. Before you panic, I still hope this will be informative and, if we are lucky, it will also be interesting. I’ve written generally in this area as part of my treatise, and that is included in your materials, so please do not worry—you will definitely have something to take home as your parting gift. By the way, I said this last year, but it is worth repeating: I love Powerpoint transitions, so I think I included every possible one that I could find. Feast your eyes.
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Let’s start with something easy. A director of a corporation is a fiduciary of the corporation. This means the director owes fiduciary duties to the corporation and one of those fiduciary duties is the duty of care. If you ask me “what does the duty of care entail,” I would tell you something very general: a duty of care requires a director to act as a reasonable director would act in the circumstances. We sometimes describe the duty of care as arising in two different contexts. The first is the oversight context or the oversight setting. As a director in the oversight context, you have a duty of care and you are supposed to be acting reasonably, but what does that mean? It means that you need to reasonably monitor the affairs of the corporation. That is, we want our directors to know what is going on. We want them to be paying attention to what is happening in the company. They should be monitoring the officers, they should be making sure information is percolating up from 25 levels below the board, etc.

Directors also act in what we might call the decision-making context. This one is obvious. Directors make decisions and, when they

* Beirne, Maynard & Parsons, L.L.P Professor of Law, University of Houston Law Center.

¹ This article contains the edited comments of Professor Moll’s presentation at the September 2018 Business Law CLE.

do, they still owe a duty of care. In effect, the duty of care in the decision-making context requires decisions to be made on a reasonably informed basis. We do not want directors making decisions on a blind or uneducated basis. We want them to gather the information that is reasonably needed to make the decision.

Mechanically, how does compliance with the duty of care happen? In other words, if you are a director and you are trying to find out what is going on—"I need to monitor the affairs of the corporation"—how do you do that? Do we expect you to speak to every single person in the corporation? After all, you need to be monitoring the affairs of the company. How are you going to do that unless you speak to everyone? From the decision-making standpoint, do we expect you to be a jack-of-all-trades? If your duty of care requires you to make reasonably informed decisions, do you need to know everything about law and accounting and investment banking and every other subject which might be pertinent to a decision? As you can hopefully tell from my inflection, the answer has to be no. It would be absurd if the answer was anything other than no—we would never get any directors to serve. You would be working more than 24 hours a day if that were possible, trying to speak to everyone in the corporation—certainly if we are talking about larger public corporations. We would not find anyone qualified to serve as a director if you had to be an expert in literally every discipline that might come before the board. I think it is fair to say that in the modern sophisticated corporation, an individual cannot be expected to learn everything on his or her own without relying on information from others. This is, I think, a somewhat obvious point. Nevertheless, I do like the way Professor Hamilton says it, so please forgive me for just reading his words very quickly:

A moment's reflection should indicate that it is inevitable that directors, particularly outside directors, will rely upon officers and employees of the corporation, other directors, accountants, engineers, lawyers, and other experts who provide information to the board of directors. Where else are outside directors to obtain information? They cannot be expected to obtain information solely from their own personal investigation of the immense and complex economic entity over which they nominally preside. Nor can they be expected to obtain this information from an examination of written reports and studies produced by the operating components of the corporation. Directors would be snowed under with paper.

This idea is easy to understand. The bottom line is that you do not have to be a jack-of-all trades. At some point, if you act like a jack-

of-all-trades, you will have no idea what you are doing. State statutes reflect this notion. Let's take a look at the Model Business Corporation Act.² The Model Act is the template for many corporation statutes in this country, including Tennessee's, as we will see in just a moment. In the Model Act, if you take a look at subsection (e) and (f) of § 8.30, notice that (e) says:

In discharging board or board committee duties, a director who does not have knowledge that makes reliance unwarranted is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (f).

Subsection (f)(1) then provides that a director can rely upon:

[O]ne or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided.

Subsection (f)(2) adds:

[L]egal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence.

And then subsection (f)(3):

[A] board committee of which the director is not a member if the director reasonably believes the committee merits confidence.

Tennessee is essentially the same statute with the words moved around a little bit. If you focus on subsections (b) and (c) of § 48-18-301, you will see basically the same language.³

² MODEL BUS. CORP. ACT § 8.30.

³ TENN. CODE ANN. § 48-18-301.

Let's talk about this reliance defense. It has several obvious (and somewhat repetitive) limitations, and these limitations often appear in the case law:

- The director has to actually rely on the information. If you are going to claim a defense under the statute, you have to prove that you did, in fact, rely. So you have to prove that you read the report, you were at a meeting where the information was orally presented, or you took some other steps to learn the information.
- You cannot rely if you are on notice that the reliance is unwarranted. We saw this explicitly stated in the statutes themselves. This defense is not designed to protect blind reliance. If you realize that there is something wrong with the opinion or report that you are getting, you are not going to be allowed to rely on it.
- You must have some reason to believe that the information being provided to you is pertinent. Directors should only rely on information that is relevant.
- You must have some reason to believe that the information relied upon is within the expertise of the person providing it. We do not want directors relying on dummies; you need some reason to believe that the person giving you the information is competent.
- You cannot rely on persons who you know to be financially interested in the transaction. The case law frequently talks about this limitation. If someone has a bias, or at least if there is a concern that they have a bias because they are financially interested, you should be skeptical and wonder if you are getting an accurate assessment.
- You cannot rely on expert advice if it is clearly inconsistent with other information before you.
- Finally, you have to question the conclusion of a report if the circumstances indicate that the conclusion is not well-founded. If there are no red flags, you are allowed to rely on an opinion or report from an expert

or fellow manager. If there are red flags, however, then not surprisingly you cannot just accept the opinion or report. Once again, we are not interested in protecting blind reliance.

These are all sensible limitations. Moreover, the statutes strike me (and probably you) as sensible because they confirm that directors, in becoming informed, are allowed to rely on experts. Let's face it, a reasonable way to get informed is to rely on people with specialized knowledge. You do not have to figure it all out yourself. On the other hand, the problem with these statutes is that, depending on how broadly we construe them, they suggest that if you get an expert opinion on a matter, you will be immunized from liability. Depending on how you feel about experts, this may set a very dangerous precedent. The statutes may encourage a board to go out and buy a desired opinion.

With this background in mind, let me raise some questions that, at least preliminarily, do not seem to have clear answers. The questions are difficult to talk about independently because they are related, so let me just try to get them on the table.

First, what type of claims do reliance statutes protect against? Let's start with duty of care claims. The reliance statutes themselves are not limited to any particular type of action. At least from the statutory language, it seems like any claim that is related to a director carrying out his or her duties—and those duties typically are fiduciary duties—would be covered by the statutes. Indeed, courts all seem to agree that reliance statutes protect against duty of care claims. For example, a director's duty to monitor may very well be satisfied by officers presenting information on what is going on in the corporation. A director's duty to monitor the officers could be satisfied by the director listening to a report of a board committee that is in charge of evaluating the performance of officers. A director's duty to make reasonably informed decisions might be satisfied by listening to reports by lawyers, investment bankers, appraisers, or other experts who are retained to provide the board with specialized information. As mentioned, the case law confirms that you do not have to figure it all out yourself. If the CFO and the finance staff tell the board that the company has enough money to pay a contemplated dividend, a director does not have to say "wait a second, I have to come to that determination myself." The director does not have to spend time and effort becoming a financial wizard (if that were even possible before the decision needed to be made) so that he or she could independently reach

that conclusion. Similarly, if a lawyer advises the board “you are in *Revlon* now and you have to comply with *Revlon* duties,” a director does not have to say “hold on— my duty of care requires me to reach that conclusion independently.” At a minimum, the reliance statutes confirm at least this point: a director does not have to become a jack-of-all-trades. Simply put, reliance on managers and other experts is permissible and is consistent with a director’s fiduciary duty of care.

What about the duty of loyalty? Directors and officers have to be acting in the corporation’s interest and not in their personal interest or in the interest of some other entity. Directors are supposed to be putting the corporation’s interest first; after all, they are fiduciaries of the corporation. There are some cases that suggest that duty of loyalty claims are covered by reliance statutes. (Once again, the statutes themselves do not limit the types of claims that they cover.) Duty of loyalty claims, by their very nature, bypass the business judgment rule because they involve conflicts. In most jurisdictions, a duty of loyalty claim gets analyzed under a fairness standard. A fairness standard typically will look at two things: (1) fair dealing—did the director deal fairly with the corporation, such as by disclosing information and negotiating fairly with the company, and (2) fair price. Fair price is basically the substantive terms of the transaction. Did the corporation get ripped off? Did it pay an appropriate amount? Even though fair dealing is relevant to the fairness inquiry, fair price tends to dominate the calculus, at least when you look at many published opinions.

Consider the following hypothetical: assume that a corporation seeks to sell off a business unit. The board obtains an appraisal from an expert who values the business unit at \$5 million. The board then sells the business unit for \$5 million to a separate company that is wholly owned by the directors themselves. The sale is a conflicted transaction, but conflict of interest transactions are not illegal per se. Assume that a shareholder later brings a derivative action claiming that the sale was unfair and that the directors breached their fiduciary duty of loyalty by effectively selling the business unit to themselves. As support, the plaintiff goes out and finds an appraiser who opines that, at the time of the sale, the business unit was worth \$8 million. Such differences in value from two different appraisers, by the way, are not that uncommon. You may have heard that “valuation is an art and not a science,” and that is certainly part of it. It could be that the appraisers are valuing the business on completely different metrics. One is looking at it from an asset value standpoint while the other is looking at it from an income value or discounted cash flow basis. It could be that one of the experts has a much rosier view of how this business unit will perform in the future. My point is simply that

valuation differences are not unrealistic. Assume that the jury ultimately credits the plaintiff's expert and concludes that the transaction is unfair and that the directors breached their duty of loyalty. The corporation wants to recover the \$3 million in damages. Does it matter that the directors went out and obtained an appraisal from a valuation expert before the transaction? Does that prevent the corporation from recovering the \$3 million from the directors?

On the one hand, I would hope so. What more do we want our directors to do? We want them to go out and seek expert advice on the fairness of a contemplated transaction. Unless the appraiser's work raises a red flag, the board should be able to rely on the \$5 million valuation. On the other hand, do we want to reduce the fairness inquiry—an inquiry that is supposed to be a very probing and rigorous standard—to what is essentially a “check the box” process? Did you get an expert who gave you an opinion that supported your position?

Let's take a look at a second question that might help us think about the first. What do reliance statutes do? Do they do more than simply acknowledge that reliance by a director is permissible? Do they provide a complete defense to liability? This is what I have been implying during our discussion, but perhaps they do not go that far. Let's remind ourselves again of the statutory language. The Model Act and Tennessee both say that a director is “entitled to rely” (that is the operative language) on managers and experts. I would suggest that this language is quite weak. It may simply convey that reliance is something that a director is allowed to do, but no more than that. It might just confirm the modest “you do not have to be a jack-of-all-trades” proposition that we talked about earlier.

Let me introduce the way that Delaware articulates this same idea. The Delaware reliance statute (Delaware General Corporation Law § 141(e)) states that a member of the board of directors shall, in the performance of duties, be “fully protected in relying” upon experts. Think about that for a moment. “Fully protected in relying” on experts seems like much stronger language. While it is possible that such language just confirms the notion that reliance on managers and other experts is permissible, it sure sounds a lot stronger to me. It sounds, perhaps, like it is outcome determinative and that it immunizes a director from liability.

What should the right result be? It seems to me that if we fully trusted experts—if we really thought that they were always ethical and helpful in our quest for truth, we would be much more comfortable concluding that reliance on experts is a complete defense to liability. On

the other hand, putting my jaded and more cynical hat on—if you believe that expert opinions in many areas are very subjective (particularly in the valuation area) or even worse, are for sale, then you would not want reliance statutes to provide a complete defense. You might want them to confirm that a director is allowed to rely on an expert, but provide no more payoff than that.

In my few remaining moments, let me ask one last question. Do reliance statutes incentivize directors to look for less knowledgeable experts who might be more inclined to provide a favorable opinion? Let me give you a quick example. In many jurisdictions, there is a doctrine called shareholder oppression that prevents those in control of a closely held company from acting in ways that might be permissible in larger publicly held companies. For example, under the shareholder oppression doctrine, terminating a shareholder's employment or refusing to declare a dividend might result in liability in a closely held company, although such actions would likely be protected by the business judgment rule in a publicly held firm. Assume that some directors of a closely held corporation wish to engage in these actions but they decide to seek legal advice first. They find a lawyer who, unbeknownst to them, does not know the first thing about the shareholder oppression doctrine. (I have met many lawyers like this, as there is very little oppression case law in many jurisdictions.) This otherwise competent attorney advises the directors that such actions are permissible, as he or she assumes that the business judgment rule would provide protection. Based on the advice, the directors terminate the shareholder's employment and refuse to declare a dividend. The shareholder sues and prevails on an oppression cause of action. Can damages be recovered? On the one hand, you would hope not. The directors did what we would want them to do—they sought legal advice before they did something, and they were told that their contemplated conduct (which has now occurred) was permissible. On the other hand, if this is a defense to liability, is there now an incentive to seek out an uninformed attorney's advice—as long as the attorney is not so uninformed that a court might deem that the directors knew the attorney was incompetent. I am out of time, and I apologize again that I do not yet have answers to these questions, but I hope we can continue the conversation in the question-and-answer period. Thank you.