DIRECTORS ON CORPORATE BOARDS MAY STILL RELY ON THEIR OWN RELIANCE ON DIRECTOR AND EXPERT REPORTS (IN MOST CASES)

Grant Thomas Williamson*

In his presentation,[1] Professor Douglas K. Moll analyzes the language that the Delaware Supreme Court chose to employ in *Smith v. Van Gorkom* in holding that the directors were not entitled to defend a claim that they breached their fiduciary duty of care on the ground that they were relying on a report made by a corporate officer.[2] Since the directors in *Smith v. Van Gorkom* did not have any traditional red flags to inform them that the report was uninformed, Professor Moll cautions that "[t]aken literally, the court's statement seems to suggest that directors cannot rely upon an uninformed report—even if the directors have no notice that the report is uninformed."[3] Professor Moll ultimately concludes that this was not the court's intent in *Smith v. Van Gorkom*, and that the court merely sought to "reaffirm the general rule – i.e., directors may not rely on information if they are on notice that the reliance is unwarranted."[4]

My comment will seek to further substantiate Professor Moll's comment as well as analyze how Tennessee courts have discussed the reliance defense that directors have in response to claims of breach of

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* Grant Williamson is a third-year law student at the University of Tennessee College of Law. The author was asked to provide a comment in response to Professor Douglas K. Moll's CLE presentation, *See* Douglas Moll, *Breach of Fiduciary Duty and the Defense of Reliance on Experts*, 20 TENN. J. BUS. L. 719 (2019), which consists of material excerpted from DOUGLAS K. MOLL & ROBERT A. RAGAZZO, CLOSELY HELD CORPORATIONS § 6.02[C][2][b] (2017).

[1] "Reliance on Information from Officers and Other Experts," consisting of material excerpted from DOUGLAS K. MOLL & ROBERT A. RAGAZZO, CLOSELY HELD CORPORATIONS § 6.02[C][2][b] (2017).

[2] Smith v. Van Gorkom, 488 A.2d 858, 874-75 (Del. 1985) (holding that although "[u]nder 8 Del.C. § 141 (e), 'directors are fully protected in relying in good faith on reports made by officers'" the directors in the case at hand did not enjoy this protection because "Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking" when presenting to the board).

[3] Moll, *supra* note 2.

[4] *Id.*

fiduciary duty of care. First, Part I will analyze the language used by the Delaware Supreme Court and seek to show that while the court may have spoken too strongly in reaching their holding, the true intent was simply, as Professor Moll posits, to reaffirm that directors cannot rely on reports when their reliance is not warranted. Next, Part II will discuss Sixth Circuit and Tennessee case law citing *Smith v. Van Gorkom* and how these courts have clarified that the general rule still applies. Part III will analyze and parse out Tennessee's corporate statutes concerning the reliance defense. Finally, Part IV will use Tennessee case law to illustrate whether directors may use their reliance on reports as a defense when claims that they breached their fiduciary duty of care are brought against them.

I. WHY THE DELAWARE SUPREME COURT REACHED ITS HOLDING IN *SMITH V. VAN GORKOM*

At first glance, the Delaware Supreme Court's holding in *Smith v. Van Gorkom* is troublesome for directors serving on corporate boards: directors are not entitled to rely on reports that were uninformed even in the absence of some kind of red flag that the report was uninformed.[5] Taken literally, the court seems to suggest that directors may be held liable for breaching their fiduciary duty of care when they rely on a report that was not adequately informed even if they had no reason to suspect that was the case. This holding would add another layer to the reliance defense[6]; it would no longer be enough that the board of directors relied in good faith on a report that they had reason to believe was adequate.[7] Reading the court's holding in this manner would require three things of the board of directors before they could rely on the reliance defense: 1) the director would have to rely on the report in good faith; 2) the director would need to reasonably believe that the report was prepared by someone whose professional expertise encompasses the subject matter of the report and whom was carefully selected by the corporation; *and* 3) the directors would now be additionally required to perform an independent analysis of the report to determine whether or not they believe the report's preparer was

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[5] *Van Gorkom*, 488 A.2d at 874–75

[6] *See* DEL. CODE ANN. tit. 8, § 141(e) (2016) ("A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.").

[7] *Id.*

adequately informed, even if there were no signs that would indicate this possibility.[8]

Fortunately for corporate boards of directors moving forward, the court's reasoning in *Van Gorkom* illustrates that their holding was not meant to transform the reliance defense, only to affirm its viability and illustrate how it did not apply under the specific case's factual circumstances. The expression "bad facts lead to bad law" is often used in the legal profession; in this case, bad facts seem to have led the Delaware Supreme Court to overstate their holding. In reaching their conclusion, however, the court noted that the directors had to make further inquiry into the report presented to them because of: "all of the surrounding circumstances -- hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever[.]"[9]

Because of the unique factual circumstances surrounding the board of directors' decision to rely on what the court deemed an uninformed report, the Delaware Supreme Court reasoned that the board of directors had a duty to inquire further into the nature of the report and how its conclusions were reached.[10] The court had stated prior in its opinion that "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[11] Taken altogether, it is evident that the Delaware Supreme Court only intended to reaffirm the general rule that directors are entitled to the reliance defense when, as mentioned earlier, 1) the director relied on the report in good faith and 2) the director reasonably believed that the report was prepared by someone whose professional expertise encompasses the subject matter of the report and whom was carefully selected by the corporation.[12] The court determined that reliance was not warranted here, however, because of the bad facts surrounding the presentation of the report; those facts led the court to hold that the board of directors was not entitled to rely on the report.[13] In

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[8] *Id.*

[9] *Van Gorkom*, 488 A.2d at 875.

[10] *See id.*

[11] *Id.* at 873.

[12] DEL. CODE ANN. tit. 8, § 141(e) (2016)

[13] *Van Gorkom*, 488 A.2d at 875 ("At a minimum for a report to enjoy the status conferred by [Del. Code Ann. tit. 8, § 141(e)] it must be pertinent to the subject matter upon which

essence, the board of directors should have known that there might be issues with the hastily prepared report and they were therefore grossly negligent in not conducting further inquiry to determine whether the report was informed or uninformed.[14]

The Delaware Supreme Court held that the directors breached their fiduciary duty of care because of: the haste with which the report was prepared; the lack of prior discussion of the transaction at issue; the urgency that time presented in the transaction; and the lack of documentation presented which should have served as red flags to the board of directors that the report was not adequately informed.[15] In essence, the circumstances in *Van Gorkom* were such blatant indicators that the report might be uninformed that the court felt the board of directors were grossly negligent in relying on what was ultimately determined to be an uninformed report and not inquiring further to determine that it was uninformed. The court's reasoning, however, does not suggest that all directors must now inquire into reports to determine whether or not they are informed and worthy of reliance; all that is required is that when red flags appear or the circumstances under which the report is prepared are suspect, that the directors perform some further inquiry to determine whether or not they are warranted in relying on that report.

II. TENNESSEE'S HANDLING OF *SMITH V. VAN GORKOM*

Of the Tennessee cases citing *Van Gorkom* that I was able to find, none of the courts cited the case for the specific issue that this comment addresses.

When the Sixth Circuit has had occasion to cite *Van Gorkom* for cases coming to the Sixth Circuit out of Tennessee, the court has not gone to the extreme of advocating that directors cannot rely upon uninformed

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a board is called to act, and otherwise be entitled to good faith, not blind, reliance. Considering all of the surrounding circumstances -- hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever -- the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans, and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.").

[14] *Id.* at 884 ("We conclude that the Board acted in a grossly negligent manner . . . and that Van Gorkom's representations on which the Board based its actions do not constitute 'reports' under [DEL. CODE ANN. tit. 8], § 141(e) on which the directors could reasonably have relied.").

[15] *See id.* at 875.

reports even in the absence of red flags[16] and has clarified that the directors in *Van Gorkom* were not warranted in relying on the reports at issue because of their "lack of knowledge and the swiftness of deliberation."[17]

III. TENNESSEE'S CORPORATE RELIANCE STATUTES

Tennessee has two corporate statutes that outline when directors may defend their actions because they were relying on a report prepared by a corporate officer. The first statute, Tennennessee Code Annotated § 48-18-301, provides the standards applicable for directors on the boards of for-profit corporations. The second statute, Tennessee Code Annotated § 48-58-301, provides similar guidance for directors serving on boards of nonprofit corporations.

The statutes generally require that a director must perform all his or her duties in good faith and reasonably given the circumstances.[18] The statutes use the word "shall" in describing the requirement that directors must perform their duties in good faith and in a reasonable manner, which implies that this is a threshold requirement for the directors to meet in order to be entitled to the reliance defenses outlined later in the statutes.[19]

The statutes[20] then go on to provide what this comment has been referring to as the reliance defense: in discharging their duties directors may rely on reports that are prepared or presented by corporate officers, among other specified parties.[21] Subsections (b)(1) of these statutes

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[16] *See* McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001) ("[T]he Delaware Supreme Court has specifically adopted gross negligence as the standard for measuring a director's liability for a breach of the duty of care.") (citing *Van Gorkom*, 488 A.2d at 872).

[17] *Campbell v. Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 801 (6th Cir. 2001) (citing *Van Gorkom*, 488 A.2d 858).

[18] TENN. CODE ANN. § 48-18-301 (2012); TENN. CODE ANN. § 48-58-301 (2012). Both statutes use identical language and formatting in describing how directors must perform their duties, whether in the nonprofit or for-profit context: "(a) A director shall discharge all duties as a director, including 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 the director reasonably believes to be in the best interests of the corporation."

[19] TENN. CODE ANN. § 48-18-301 (2012); TENN. CODE ANN. § 48-58-301 (2012).

[20] *Id.*

[21] Here the statutes differ slightly. TENN. CODE ANN. § 48-18-301 (2012), which deals with for-profit corporations states:

provide the caveat that directors may rely on these reports only when the director "reasonably believes [the report preparer] to be reliable and competent in the matters presented."[22] Part of reasonably believing that the report preparer is reliable is viewing the presentation in light of all the circumstances around it, which is something the Delaware Supreme Court did not believe the board did in *Van Gorkom*.[23]

Following this reading, gross negligence would be the standard for determining whether a director is able to rely on a report. If, given all the circumstances and any possible red flags, the director would be grossly negligent not to inquire further into whether the report was informed or uninformed, then the director cannot blindly rely on the report. If, however, there are no red flags and the circumstances do not warrant further inquiry, then the director would not be grossly negligent in relying on a report even when it is later determined that the report was uninformed.

> (b) In discharging such duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
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> (1) One (1) or more officers or employees of the corporation (or a subsidiary of the corporation) whom the director reasonably believes to be reliable and competent in the matters presented;
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> (2) Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
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> (3) A committee of the board of directors of which the director is not a member, if the director reasonably believes the committee merits confidence.
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> (c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.
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> (d) A director is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of the office in compliance with this section.

TENN. CODE ANN. § 48-58-301 (2012), which deals with nonprofit corporations, adds an additional subsection under subsection (b) that states "(4) One (1) or more volunteers of the corporation whom the director reasonably believes to be reliable and competent in the matters presented" and adds the following language to the end of subsection (d): "or if the director is immune from suit under § 48-58-601."

[22] *Supra* note 20.

[23] *See generally Van Gorkom*, 488 A.2d 858 (Del. 1985).

IV. TENNESSEE CASE LAW DETAILING THE NATURE OF A DIRECTOR'S DUTIES

Describing the business judgment rule, the Tennessee Court of Appeals has stressed that the inquiry is into whether a board of directors "has acted in good faith and in the exercise of honest judgment."[24] Directors can be liable when their negligence has caused injury to the corporation and by extension to its shareholders.[25] In order to truly act in good faith while exercising honest judgment and avoiding negligence, "directors . . . must be diligent and careful in performing their duties" and can be "chargeable with knowledge actually possessed *or which he might have possessed had he [or she] diligently discharged his functions*."[26] Therefore, if circumstances warrant that a diligent and careful director would inquire further into whether a report is informed or uninformed, a director will not be able to rely on that report by foregoing any inquiry.[27]

Put simply, "the duty of care required of directors and officers is 'to act in good-faith and in the best interest of the corporation with the care an ordinarily prudent person in a like position would exercise under

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[24] Lewis ex rel. Citizens Sav. Bank & Trust Co. v. Boyd, 838 S.W.2d 215, 220–21 (Tenn. Ct. App. 1992) ("[L]ike other courts following the business judgment rule, [Tennessee courts] presume that a corporation's directors, when making a business decision, acted on an informed basis, in good faith, and with the honest belief that their decision was in the corporation's best interests.").

[25] *See* Neese v. Brown, 405 S.W.2d 577, 580 (Tenn. Ct. App. 1964) ("the liability of the directors . . . of a corporation is not limited to wilful breaches of trust or excessive power but also extends to negligence.").

[26] *Id* (quoting Fletcher's Private Corporations, Vol. 3, 1947 Rev. Ed., sec. 1029, page 54) (emphasis added).

[27] *See* Neese, 405 S.W.2d at 580–81("Directors, by assuming office, agree to give as much of their time and attention to the duties assumed as the proper care of the interests intrusted to them may require. . . . The diligence required from them has been defined as that exercised by prudent men about their own affairs, being that degree of diligence characterized as ordinary. If a less degree of diligence is exercised, the negligence is gross, and for losses consequent he is liable." (quoting Wallace v. Lincoln Sav. Bank, 15 S.W. 448, 453–54 (1890)).

similar circumstances. . . .[28]"' In order to take advantage of the reliance defense, a director must be diligent in his or her reliance on a report.[29]

CONCLUSION

The Delaware Supreme Court was presented with a board of directors that was grossly negligent and did not act with even the minimal amount of diligence that would have led them to realize that the report they were relying on was uninformed. While the language in the court's holding might suggest that directors cannot rely on uninformed reports even in the absence of red flags, the court's reasoning shows that the court's intent was simply to further the rule that a report cannot be relied upon when that reliance is not reasonably warranted. In Tennessee, reliance on a report is not warranted when viewing the circumstances surrounding the presentation of the report would lead a reasonable person exercising ordinary diligence to conduct further inquiry into whether the report was informed or uninformed.

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[28] Franklin Capital Assocs. v. Almost Family, Inc., 194 S.W.3d 392, 400 (Tenn. Ct. App. 2005) (quoting in part Hall v. Tenn. Dressed Beef Co., No. 701-A-01-9510-CH-00430, 1996 WL 355074, *6 (Tenn. Ct. App. November 25, 1996)). In the Hall decision, the court quoted Tenn. Code Ann. §§ 48-18-301(a), -403(a) and cited Neese, 405 S.W.2d at 580 in formulating the language that the Franklin Capital Assocs. court quoted in its formulation of what the duty of care requires.

[29] *See generally* Am. Network Grp. v. Kostyk, No. 01A01-9405-CH-00219, 1994 Ct. App. LEXIS 619, at *21 (Tenn. Ct. App. Oct. 26, 1994) ("We see no reason why an executive officer of a corporation should not be held responsible to the corporation resulting from his lack of diligence." "A corporate executive owes a duty to exercise not less than ordinary diligence to the requirements of his position."). *Id.*