

THE SOCIAL COST OF DUE CARE IN BUSINESS JUDGMENT

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Introduction

This article considers whether it is justifiable to reduce damages where directors are liable for business failure. It argues that holding directors liable for all damage due to business failure prevents individual directors from doing business enterprisingly. According to a cost-benefit analysis, the fear of potential liability results in excessive costs when business decisions are made. The total costs that individual directors expend in making business decisions is smaller than the total costs of the company as the company's costs includes not only directors' costs but also other employees' costs. In comparison, the total amount of loss that individual directors may suffer due to a business failure is far larger than the total loss of the company, where the directors are liable for the total loss of the company jointly and severally. It is because the directors would also suffer salary reduction or discharge. Under these circumstances, the directors should pay close attention in order not to err in their business judgment. Thus, even where risks are minimal, directors may act too cautiously and passively, rather than pursue a more profitable entrepreneurship aggressively. Therefore, the simple compensatory principle may not be adequate where business failure occurs.

In most situations, there is a standard which determines whether someone is liable and then the amount of damages for which he is liable depends on the loss suffered. If the courts decrease the standard of care which determines when directors are liable, so that they are entitled to take increased risks, some directors will not be liable under the new system when they would be under the old. Still, those who were liable under the new system will normally be liable for the same amount as they were before. For example, in the American case of *Gorkom*¹, the directors were required to pay more than \$23 million in damages for the company's loss according to the strict compensatory principle. However, this case was severely criticized because the decision caused

qualified managers to hesitate when considering whether to act as a director. This can be inferred not only through an economic analysis of law but also by considering the special relationship between the director and company, i.e. the fiduciary-principal relationship, which results from the separation of ownership and control. On the contrary, in the *Walt Disney Case*² of 2005, where directors decided to give \$140 million to the former president as termination compensation after one year's service, the directors were not held liable due to the business judgment rule.

However, in South Korea, in the *Samsung Electronics Case*,³ the court reduced the amount of damages payable by the directors to 20% of the company's pure economic loss. This judgment is distinctive because it is a new trial in terms of reducing the amount of liability rather than reducing the standard of care for liability. On the 27th of December 2001, the Suwon District Court held nine former and current directors of Samsung Electronics jointly and severally liable for 90.28 billion Korean won (approximately 70 million US dollars) for having neglected their duties. However, the Seoul High Court rejected some of the alleged breaches of duty and at the same time reduced the amount of damages on the 20th of November 2003. Thereafter, the Supreme Court of Korea affirmed the judgment of the Seoul High Court on the 28th of October 2005. These decisions reveal how Korean courts apply the business judgment rule, on which the defendants had relied.⁴

This article uses economic analysis of law to estimate the degree of care directors would be willing to pay under the precedents that do not reduce the amount of director's liability and only make the decision between whether they are liable for

¹ Smith v. Van Gorkom, 488 A.2d 858, Del., 1985.

² In re The Walt Disney Company Derivative Litigation, No. Civ. A. 15452.

³ Supreme Court decision of 2005.10.28, 2003da69638

⁴ See Hwa-Jin Kim, "Directors' Duties and Liabilities in Corporate Control and Restructuring Transactions: Recent Developments in Korea", (2006) Oxford U Comparative L Forum 2 at ouclf.iuscomp.org, text after note 30.

everything or for nothing. This analysis will reveal that it is necessary to reduce director's liability to a certain portion of the total loss of the company as in the Korean case above. Part I analyzes the total social cost of exercising due diligence and care in business judgment. Part II compares the director's incentives under the liability rule and the no-liability rule.

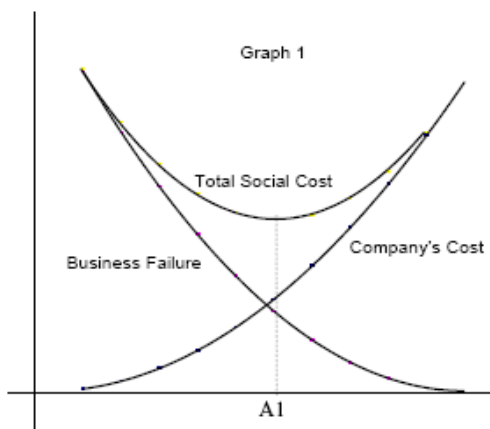
In addition, Part III demonstrates that the damages payable by a director who is also a controlling shareholder, who derives private benefits from the company, should be greater than those for ordinary directors. If it comes to a controlling shareholder director, according to cost-benefit analysis, a controlling shareholder director would pay less attention than other directors. The costs that a controlling shareholder director should pay in order to make good business decisions are larger than the total amount of individual directors' costs because a controlling shareholder director must control the other directors on top of the costs to make good business decision. On the other hand, the loss that a controlling shareholder director would suffer due to business failure would be smaller than the total amount of individual directors' loss. It is because a controlling shareholder director does not have to worry about discharge unless the company becomes bankrupt. As a result, it would be proper to pose heavier liability upon a controlling shareholder director than the other directors.

I. Total Social Cost of Due Care

The total social cost of due care would amount to the cost that the company expends to exercise due care in business judgment plus the loss the company would suffer when the business judgment brings about bad consequences, multiplied by the risk.

A. The Cost of Exercising Due Care in Business Judgment

The cost of exercising due care in business judgment can be divided into three areas: the cost of making business judgments, the cost of employing and supervising directors and the opportunity cost of risk-taking entrepreneurship. These are the costs of reducing the management errors of directors. The curve is upward sloping. This is in line with the total social cost when the director's fiduciary duty of due care is selected to be at a high level. Conversely, higher levels of the fiduciary duty of due care will reduce the probability of wrong management decisions being made. However, since the due care of the director entails company expenses, the level of care required is justified based on expenses payable depending on its financial situation. The socially optimal amount of due care is A1 in Graph 1.



1. Cost of Making Business Judgments

Manpower, expenses, and time are spent in analyzing data to make correct business decision. Manpower and expenses (costs in producing data, consulting costs, etc) are incurred in predicting the future. Data must be generated in order to predict the future and time is spent reading and analyzing such data. The care expended by the director incurs direct and indirect costs on the company and these costs must maintain an appropriate proportion with the company's payoffs gained by the director's care. For example, if both a director of a company that exports \$10,000 worth of toys and a director of a company that exports \$10 million worth of electronic appliances misunderstand the importing country's tariff laws, they cannot be held equally responsible in terms of damages because the losses would be unequal. Therefore the director of the electronic appliances company would be willing to pay more to prevent such misunderstanding of the importing country's tariff laws than the director of the toy company. In order to fully understand the importing country's policy on dumping, it is necessary to have an international trade lawyer as a consultant. The capacity of the director himself is also connected with the costs. The director needs to be highly skilled in order to be critical of the tariff policies, to hire a capable lawyer as a consultant and understand his advice. The company, therefore, must be prepared to pay a high salary to such qualified directors and this is part of the director selection cost. This shows that the expected damages actually determine the degree of care or the amount of costs directors would pay.

In the United States, the *Gorkom Case*⁵ triggered a re-evaluation of the business decision-making process of the board of directors of a company. No matter how good the results, all decisions by directors must be made in accordance with the appropriate

⁵ Smith v. Van Gorkom, 488 A.2d 858, Del., 1985.

procedures. This is because there is always a possibility of derivative litigation if shareholders are not 100% satisfied. For example, in the *Walt Disney Case*⁶, the length of meetings and whether copies of written materials were consulted became issues of concern. To require already overworked directors to hold meetings at length for every matter and to produce written documents or materials costs much time and monetary resources. This procedure includes verification of the data, meetings between directors, and consulting outside experts. On the other hand, if these procedures are taken, directors are protected by the Business Judgment Rule even when they oppose decisions and transactions that are desired by the majority of shareholders.

After *Gorkom*⁷, shareholders became capable of pursuing derivative litigation if they could prove that directors did not spend adequate time in their business decision-making. This caused directors to justify their decision-making and show that their decision was based on their best judgment by leaving paper trails and consulting outside experts. If strict company bylaws and regulations are enforced in important decision-making procedures to prevent director negligence it may inevitably lead to inefficiency since less important decisions must follow the same procedures.

2. Cost of Employing and Supervising Directors

Expenses and time are spent in hiring capable directors who are able to make sound business decisions. One of the biggest problems when the director's fiduciary duty of care is selected to be at an excessively high level is that the danger of liability would reduce the overall pool of people wanting to be directors. As a result, not only incapable but also capable managers become reluctant to be hired as directors. In fact, after the *Gorkom Case*⁸, many capable managers avoided being hired as a director because of the possibility of having to be held responsible for making the wrong business decisions. This is why Delaware State legislated Section 102(b)(7) of the Delaware General Corporation Law so that in the case of a breach of a fiduciary duty of due care, directors can have damages reduced in accordance with company bylaws. Reducing opportunities for companies to hire capable managers who can increase the efficiency of the company by good management which consequently increase society's productivity is a loss to society as a whole. As a result, if incompetent directors are hired, the

costs of training and monitoring them will prove to be more expensive. In addition, the company will have to offer a higher salary than in the past, because a rise in the probability of having to pay damages will cause the insurance premium to rise, which results in an increase in company expenses.

3. Opportunity Cost of Risk-taking Entrepreneurship

If the director's fiduciary duty of care is selected to be at a high level, this may discourage the entrepreneurship spirit of the management team. Active and enterprising business decisions of the directors must be respected. Korea was able to achieve its remarkable economic development by investing heavily, some may say rashly, in venture business. A passive and overtly risk-averse approach to management may cause companies to miss opportunities for breakthroughs by not being able to respond to situations where change is necessary. A passive management approach by directors in order to avoid responsibility in case of failure is not beneficial to society. After *Gorkom*⁹, directors displayed an excessively cautious approach to management in order to avoid being held responsible for breaching the fiduciary duty of care. An overtly careful and passive attitude in making business decisions may cause companies to lose opportunities to capitalize on profitable business opportunities. Being overtly risk-averse may cause directors to not only miss business opportunities that require quick response, but it will also prevent companies from undertaking risky but extremely profitable business opportunities.

B. The Cost Internalized by the Directors

If we could split the total cost into the cost to the company and the cost to directors, among these three elements - costs of making business judgments, costs of employing and supervising directors, and opportunity costs of risk-taking entrepreneurship, the latter two are not completely internalized by the directors, but a fraction always is. Manpower, expenses, and time are all spent in analyzing materials for business decision-making. However, judging from the personal incentive of the director, the only personal cost for the director is time. The company's manpower and expenses are part of the company's cost. Company costs are a part of social costs but not a part of the personal costs of the director.

Most of the opportunity costs of taking an overly careful and passive attitude in making business decisions are part of the company's cost. The opportunity to increase society's productivity – maximizing society's "pie" – will be lost by the

⁶ In re The Walt Disney Company Derivative Litigation, No. Civ. A. 15452.

⁷ Smith v. Van Gorkom, 488 A.2d 858, Del., 1985.

⁸ Smith v. Van Gorkom, 488 A.2d 858, Del., 1985.

⁹ Smith v. Van Gorkom, 488 A.2d 858, Del., 1985.

overtly careful and passive attitude of the directors. Such an attitude can only affect the personal costs of the director by having lost the opportunity to increase salary, to improve reputation or to retain a more prestigious title, etc. However, if the risk of heavy liability for the damages of business failure is greater than the merits of these opportunities, directors would play cautiously.

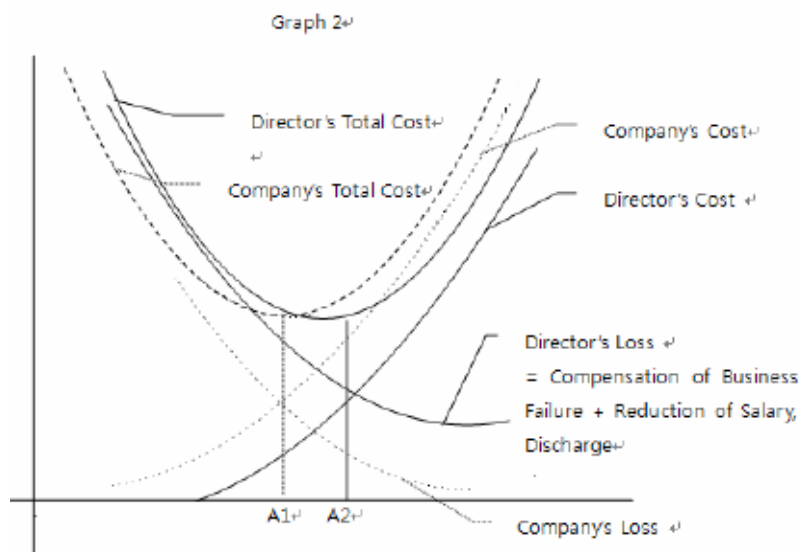
Moreover, the costs of hiring and monitoring directors are part of overall social costs, but it is not a part of the private costs of directors. The director is the subject of such hiring and monitoring costs. The costs of hiring a director are taken on at the general meeting of shareholders. The costs of monitoring the director who has been hired at the general meeting must also be taken on by the shareholders and the auditor because it is at the general meeting that a director can be hired and fired. However, in practice, most of such costs are borne by the controlling shareholder director.

If individual directors are not held responsible for damages, an incorrect business decision would only result in the reduction of salary or layoffs. The cost of individual directors would only include time spent analyzing relevant data and missing the opportunity of bonus due to successful achievements. Therefore the social costs of a wrong business decision by directors are not completely internalized by the directors, but a fraction of it always is. However, if the total damages are held responsible by individual directors, an incorrect business decision

would trigger a too hefty burden on the directors, which is much heavier than socially desirable. Most directors would be unable to meet such heavy damages anyway, and it may result in bankruptcy. For this reason, directors are usually insured against such damages, but mostly the company pays the insurance fee. Thus, the social costs are not entirely internalized to the directors themselves. Nonetheless, one could argue that even though the directors won't be able to pay the full damages, they should be held liable for them as a symbolic measure. It may be so, but it could also discourage director's entrepreneurship.

II. Level of Due Care Directors Would Exercise

If directors are held liable for total company loss, the level of due care they would decide to exercise would be A2, which is higher than A1, in Graph 2. Let's see how the graph changes when the directors are held liable for total company loss in accordance with the absolute liability principle. Then, the company can claim total damages from the directors. Where the company incurs a loss due to a decision passed by the board of directors, all the directors on the board are held responsible for paying the damages jointly. The directors must pay damages to the company jointly, and the internal relationship and role of the directors are left for them to decide upon.



As you can see in Graph 2, there are big differences in many areas between the total cost of the company and the joint costs of the directors. It is because the cost to directors is less than the cost to the company, and also the directors' loss includes the risk

of reduction in salary or firing on top of the company's loss, they are liable for. If the directors are made to jointly compensate for the loss of the company, the actual loss of directors further includes the threat of reduction in salary and firing, which makes their loss curve higher than the society's loss curve. The threat of reduction in salary and firing of the directors is not a question of

efficiency but of distribution, and hence is not included in overall social costs. On the other hand, the loss of opportunities for capable managers to be hired as directors and create productive business is surely a social cost. This cost arises each time directors are imposed to pay high damages. Thus, as the director's fiduciary duty of care is selected to be at higher levels, social costs would increase.

The curve representing the costs of directors as a whole is below the curve representing overall social cost, because the costs borne by directors are only a fraction of the costs borne by the company as a whole. Selecting the duty of care to be at higher levels, the costs of directors include the increase in working hours and intensity and loss in opportunities of receiving a bonus following a success of risky business. These costs in terms of overall social costs are lower than the opportunity cost of venture investment and costs of hiring and monitoring a new director.

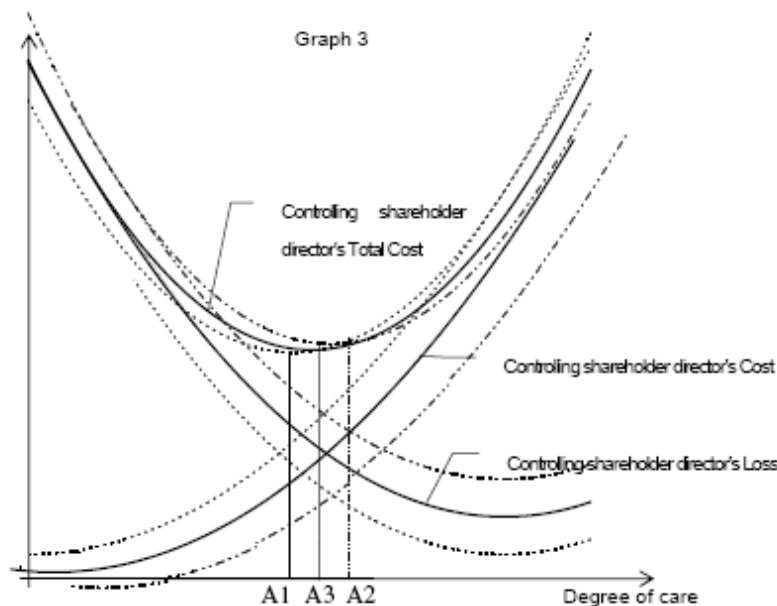
The curve of aggregate costs of directors, which is the sum of the directors' loss and costs, shifts to the right of the U-shaped curve representing overall social costs. It follows that the level of due care that the directors decide to follow, A2, is higher than the socially optimal, A1. When the directors are made to jointly compensate for company loss, they decide upon costs for a level of due care that is higher than the socially optimal level.

Thus, if the damages for which directors are liable for bad consequences are reduced to less than the company's total loss, then A2 could become closer to A1. In such cases, this article argues that the

damages payable by the directors should be reduced, so that the directors can decide upon a lower level of due care. It might be for such reasons that the Supreme Court of Korea reduced the damages payable by directors to 20% of the company's pure economic loss in the *Samsung Electronics Case*. However, it is unclear why the reduction was to 20% of pure economic loss.

III. Controlling shareholder director

The director who is also a controlling shareholder director shows a slightly different loss curve and cost curve from the typical director, because he could derive private benefits from the company. Manpower and costs spent to analyze material and data for business decision-making are not calculated as the individual costs of the controlling shareholder director but as the costs incurred by the company. However, the opportunity costs of excessively careful and passive business decision-making – losing the opportunity to grow rapidly – can be calculated as costs also for the director who is also a controlling shareholder director. This is since directors who are also controlling shareholder directors derive private benefits from the company which acts as an incentive to aggressively take on somewhat risky business opportunities. Thus, being too careful in taking on such activities due to the fear of having to pay damages to the company also becomes another cost by reducing the private benefits of the director who is also a controlling shareholder director.



Taking a higher degree of care in this graph means that the company or the director produces more

procedural evidence which can be illustrated to prove their due care at a trial. If a director pays a high degree of care, it means he would be more cautious, passive and slow

in business decision making. If a director pays a lower degree of care, it means he would be active, quick and prompt in making risky but more profitable decision. Thus, the degree of care does not actually reflect the value of the shares at the stock exchange market. Sometimes, quick and prompt decision making saves the procedural costs and time, and furthermore makes possible adventurous heavy investment.

Directors who derive private benefits from the company by also acting as a controlling shareholder director have additional costs of employing and supervising fiduciaries in order to ensure that they carry out the duty of due care and duty of loyalty. Shareholding directors can spend personal costs apart from company costs in employing and supervising fiduciaries. It costs controlling shareholder directors to employ directors who will follow and execute shareholders' needs. However, this cost may be used to supervise directors in order to reduce business decisions that result in failures.

On the other hand, it can increase the probability of failure when the shareholders push for investing in a risky business opportunity. For example, in the *Walt Disney Case*¹⁰, the costs that Eisner incurred in employing and supervising directors resulted in increasing business decisions that resulted in failures. Then, since these costs have no effect on society, they must be minimized. The pitfall is that the controlling shareholder director's private costs of employing and supervising directors are not internalized by the company. The personal costs of employing and supervising ordinary directors that a controlling shareholder director put in are part of the controlling shareholder director's costs, since it is a care taken privately. However, it is not part of the company's costs.

A controlling shareholder director incurs additional costs when he or she tries to pursue private benefits. A controlling shareholder director would have to spend more costs in controlling other directors so that the company will be managed in a way that the controlling shareholder director wants. In Graph 3, it is clear that the costs of a controlling shareholder director are significantly higher than those of ordinary directors because a controlling shareholder director can derive private benefits. The level of due care that a controlling shareholder director would be willing to pay is at A3, which is below A2, the level of due care that ordinary directors would be willing to pay. This means a controlling shareholder director would tend to prefer riskier but more profitable entrepreneurship than ordinary directors do. An increase in the responsibilities of a controlling shareholder director will result in a reduction of their incentive to rashly

over-invest. Therefore damages payable by a controlling shareholder director should be higher than that of directors who cannot derive private benefits in order to have the level of due care at the socially optimal level. As a result, the reduction of liability for the controlling shareholder director should be smaller than those for ordinary directors.

In addition, it is not beneficial to have a controlling shareholder director liable to pay damages. Private benefits derived from venture investing are merely part of the development of the company and all benefits from the development cannot be extracted as private benefits. Thus, even a controlling shareholder cannot internalize all company costs but only a fraction of total company costs. It follows that, if shareholding directors are held jointly liable for total company loss, the level of due care will be at A3 which is above A1, the socially optimal level, but below A2. A controlling shareholder director who derives private benefits invests rashly in order to increase their private benefits, but the level of care he or she would be willing to pay is still above A1 which is the social optimal. Thus, the damages payable for the controlling shareholder director should be greater than those for the ordinary directors, but less than the company's total loss.

CONCLUSION

It would be an excessive penalty to hold directors jointly liable for total company loss. Entrepreneurship would be discouraged. The total amount of loss that individual directors might suffer due to a business failure is larger than the total loss of the company because the directors would also have to suffer the loss of salary or discharge and the total amount of costs that individual directors pay to make good business decision is smaller than the total costs of the company. Therefore, under the severe liability rule, directors would pay excessively higher degree of care to make a business judgment than the degree of care that is socially desirable. Thus, it is necessary to reduce the directors' liability to less than the total amount of loss of the company.

In the *Samsung Electronics Case*, the Supreme Court reduced the damages payable by the directors to 20% of real loss in accordance with the Principle of Equal Compensation, which is a decision that should be welcomed. However, what is regretful is that the court could not show any sure guidance how much to reduce the directors' liability. If the criteria fluctuate, it will increase the transaction cost.

As Coase said, the rights of the various parties should be well-defined and the results of legal actions should be easy to forecast.¹¹

¹⁰ In re The Walt Disney Company Derivative Litigation, No. Civ. A. 15452.

¹¹ Ronald H. Coase, "The Problem of Social Cost", *Journal of Law and Economics* (October 1960), at 19.

“It would therefore seem desirable that the courts should understand the economic consequences of their decisions and should, insofar as this is possible without creating too much uncertainty about the legal position itself, take these consequences into account when making their decisions.”¹²

Therefore imposing reduction of directors’ liability *ex ante* to breach would be more effective in inducing directors to exercise due care than reducing the directors’ liability *ex post* breach in the court. Thus, we should consider the approach of the Principles of Corporate Governance to limit director’s liability, which permits a provision in a certificate of incorporation that limits damages against a director for business failure to a certain amount,¹³ rather than the method giving courts the power to reduce the directors’ liability case by case.

¹² Id.

¹³ 1 Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations §7.19 (1992). See also Section 102(b)(7) of the Delaware General Corporation Law.