

Standards of Disciplinary Conduct for the Corporate Directors: Perspective of the United States of America

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Abstract

Administration of corporate activity is the daily preoccupation of corporate directors. Delegation of decision-making to the director, who is an independent player within the company, can clearly create the risk of conflicting his interests with the interests of the shareholders. This potential conflict of interests is a consequence of the division of ownership of the company and the control powers of the company's commercial activity. The delegation of decision-making authority to the directors of the company may cause the risk of the temptation of the director to the assets of the company. In addition, directors may also be tempted by opportunities for profit that arise during the exercise of their function, instead of using these opportunities for the company. For this reason, it is necessary to foresee clear disciplinary parameters, to avoid and eliminate the conflict of interest, as well as the prohibition of competition. In the present paper, through a legal assessment, special attention has been paid to the main categories of standards: elimination of conflict of interest and prohibition of competition. The main aim of this paper is to analyze the US doctrine, legal provisions, which regulate the two standards of disciplinary conduct for the corporate directors, as well as the court practice in this regard. Also, an important objective of this paper is that it may serve as an important basis for further comparative studies in this field with other jurisdictions. Such analysis is based on the qualitative method, which contains also the research, analytical, descriptive, interpretive methods. The result of this paper will stimulate debate in the academic level and contribute to further improvements of our company legislation, as well to the legal doctrine in Albania that lacks such.

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1. Introduction

In the present paper, through a legal assessment, special attention has been paid to the main categories of standards elaborated in the USA legislation: *elimination of conflict of interest and prohibition of competition*. This paper does not purport to serve as an exhaustive analysis of the above documents, but rather, aims to provide a general overview of the regulatory approach in relation to standards of disciplinary conduct for the corporate directors in USA.

The primary goal in the present paper is the legal analysis of the main categories of standards elaborated in the USA legislation: *elimination of conflict of interest and prohibition of competition*. Such analysis is based on the qualitative method, which contains also the research, analytical, descriptive, interpretive methods.

We conclude that this paper is an attempt to make an important contribution to this specific topic, which may serve as an important basis for further comparative studies in this field with other jurisdictions, as well as an example that will stimulate improvement to our company legislation.

2. Elimination of conflict of interest

In most American states, conflict of interest is defined as a "transaction between a corporation and one or more directors or an organization in which one or more of its directors have a financial interest".³ The Corporate Business Model Act (CBA) also contains provisions on conflict of interest transactions. According to this act, a transaction in conflict of interest is a transaction carried out or proposed to be carried out by the corporation or an entity controlled by the corporation where the director or a related person is a party or has a material financial interest.⁴

In the case "Cede & Co v. Technicolor Inc.", the Delaware Civil Court and Supreme Court tried to determine the "materiality" of directors' interests.⁵ If the interest appears to be "material", the director will be deprived of the protection of the business rule. The American doctrine states that the person who has given approval for this transaction cannot go to court to oppose this transaction. Consequently, plaintiffs before contesting a director's action must meet certain criteria themselves.⁶

Based on AMKB, transactions in conflict of interest will not be subject to judicial review for impartiality.⁷ The notion of impartiality includes the responsibility of the directors in carrying out transactions which, apart from the favorable price, are

³ Baums Th., & Keneth S. "Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany". Working paper series no.16, Institute for Law and Finance, Frankfurt. 2005. p. 11-12. Available online at: http://www.ilf-frankfurt.de/uploads/media/ILF_WP_016.pdf, last access on 20.02.2015.

⁴ Ibid.

⁵ Welch E. P., & Turezyn A. J. *Folk on the Delaware General Corporation Law*, Aspen Publishers, 2005. p. 108.

⁶ David A. Drexler, Lewis S. Black, Jr., A. Gilchrist Sparks, III, *Delaware corporation law and practice*. New York, 2010. p.11-15

⁷ Welch E. P., & Turezyn A. J., *op. cit.*, p.111.

entirely for the benefit of the corporation. In some jurisdictions, impartiality in a transaction does not need to be proven or established if formal approval has been given by the disinterested directors or shareholders of the corporation.⁸

These jurisdictions have not paid attention to whether the approval will be given by the majority shareholder or the minority shareholders. But in case we are faced with a transaction with a controlling party, then the review of the terms of the agreement by an external and independent judicial monitor is the only protection of the interests of minority shareholders.⁹ The defects of this legal arrangement leave considerable room for controlling persons to manipulate formal approval processes for their own interests.

In these circumstances, it is necessary to design a clearer norm for these types of transactions, focusing more on the persons who possess the power of corporate control than on the persons who simply have a managerial position.¹⁰ Also, this norm should provide a protection, which is not based on the formal approval process, but on the impartiality of the transactions. The approach to self-dealing has not been very flexible in the USA. Actions by themselves were automatically considered void.¹¹

The American doctrine has maintained that this "black and white" rule would prevent the normal development of the commercial activity of the corporation.¹² These actions did not need to be declared invalid, if they were in the benefit and interest of the corporation. For example, the reluctance of banks and other financial institutions to invest in various projects of a corporation, forced the directors to make decisions to grant loans to the corporation.¹³ Such an agreement would be considered in the best interest of the corporation and would not be subject to judicial review. Referring to these reasons, even the approach in favor of such transactions changed.¹⁴

The American legislature specified the methods by which transactions between a director and the corporation can be "cleared" of the suspicion of the existence of a material personal interest.¹⁵ In the state of Delaware, these three methods are specified in Section 144 of the Corporation Law.

Based on the first method, the transaction will be considered valid if disinterested and independent members of the council give approval for the conflicting transaction. Under the second method, the conflicting transaction will be considered valid if disinterested shareholders give their approval for this transaction.

Meanwhile the third method is related to the defendant, who must prove that the transaction was completely fair in order to consider it valid. According to this

⁸ Colley J. L., *Corporate governance*. The McGraw Hill Companies, New York, 2003.p. 58.

⁹ David A. Drexler, Lewis S. Black, Jr., A. Gilchrist Sparks, III, *op. cit.*, p.15-17

¹⁰ Baums Th., & Keneth S., *op. cit.*, p. 4.

¹¹ Ibid.

¹¹ Hamilton R. W., *The Law of Corporations in a Nutshell*. West Publishing Co. St.Paul, 1987. p. 468.

¹² Clarke D., *Three Concepts of the Independent Directors*. Delaware Corporate law Journal, Vol. 32, 2007, p. 107.

¹³ Ibid.

¹⁴ Hamilton R. W., *op. cit.*, p. 468.

¹⁵ Hill C. A., & Painter R. W. *Compromised fiduciaries: Conflicts of interest in Government and Business*. Minesota Law Review, Vol. 95, 2010, p. 1652. Available online at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1922838, last access on October 31, 2023.

method, it must be demonstrated not only that the company followed a fair procedure, but also that the transaction contained essentially fair terms.¹⁶ In case one of the abovementioned methods should be applied, the director will not be considered responsible for the violations. As per above, self-transactions are not completely prohibited if one of the aforementioned methods is used.¹⁷

But even the application of these methods is associated with numerous issues, which are related to the failure to distinguish between abuse of control and abuse of trust.¹⁸ Delaware corporate law rules cover transactions between the corporation and an (outside) director, who does not control the decision of the board of directors or the management of the corporation. The problem, in such cases, lies on the amount of support given to persons who have an interest and who have not notified the chairman of the board of directors and the board of directors themselves, when they make their decision.¹⁹

Delaware corporate law provisions do not govern transactions with a controlling party²⁰ that is not a member of the board of directors. American courts have attempted to fill this legislative gap, treating a controlling shareholder as a "fiduciary".

Also, the courts states that the director is considered "disinterested" if there is no direct financial benefit from the transaction, regardless of the degree of control over their election and the continuous presence on the board, exercised by the party who benefits from it. But the term "disinterested" is not the same as the term "independent". Consequently, the required approval does not guarantee certainty when negotiating an agreement.²¹

Any decision made by a member of the board of directors may reflect a conflict of interest. It is for this reason that pressure has been exerted on the courts to review business decisions.²² But in fact, in case of conflict of interest, the courts have applied the business judgment rule in the decisions of the corporate directors. Specifically, courts in the state of Delaware have limited judicial review of transactions involving members of the board of directors, respecting the business judgment rule if a majority of disinterested directors has given approval to these transactions.²³

In the Disney case²⁴, shareholders challenged the decision of the Disney corporate board to hire a friend of the CEO. The shareholders claimed that the council was influenced by the general director, Mr. Michael Eisner.²⁵ While the Court assessed that the majority of the board of directors - including the director of the elementary

¹⁶ Ibid.

¹⁷ Clarke D., *op. cit.*, p. 107.

¹⁸ Hamilton R. W., *op. cit.*, p. 474.

¹⁹ Welch E. P., & Turezyn A. J., *op. cit.*, p.111.

²⁰ *It may be the mother company or the majority shareholder.*

²¹ Baums Th., & Keneth S., *op. cit.*, p. 4.

²² Hill C. A., & Painter R. W., *op. cit.*, p. 1652.

²³ Gevurtz F., *Disney in a Comparative Light*, 2007, p. 3 Available online at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=965596, last access on November 1, 2023.

²⁴ *In re Walt Disney co. Derivative Litigation* 906 A.2d 27, Delaware, 2006.

²⁵ Hill C. A., & Painter R. W., *op. cit.*, p.1654.

school of the children of Mr. Eisner – were not influenced by Mr. Eisner.²⁶

Despite the court's findings that the Disney corporate board had met the legal standard of independence, the general consensus was that the board of directors was not independent.²⁷ Indeed, the Court of Delaware respected the decision of the board of directors, despite the finding that personal relationships could have influenced the decision-making.²⁸

Whereas in the "Steam vs Stewart" case, the Delaware Supreme Court dismissed the lawsuit brought by the shareholder, who claimed that the member of the board of directors, Ms. Martha Stewart, had violated the obligations to the corporation and that most of the council members were influenced by the defendant and could not file a lawsuit against her.²⁹

The Delaware Supreme Court decided to dismiss the case with the argument that only the board of directors of the corporation could go to court with a lawsuit and that shareholders should have more faith in the directors of the board.³⁰

In the last twenty years, both doctrine and American jurisprudence have emphasized independent boards, with the hope that they will be better observers. Also, the independence of the board should not be determined by reference to some relations, such as close family relation or a business partnership or contractual relation, but should exist essentially.

3. Prohibition of competition

Corporate directors are prohibited from competing with the corporation's activity or benefiting from its opportunities. In American doctrine there are different approaches regarding this limitation.

Part of the doctrine states that different jurisdictions have difficulties in determining the acquisition of corporate opportunities and competition with it.³¹ Another part takes the position that no such difficulties exist and that the legislature in these jurisdictions finds it easy to define the parameters when the interest of a director is opposed to the interest of the corporation.

While the rest of the doctrine finds as a solution to these difficulties the information and approval of transactions of corporate directors by disinterested parties.³²

Delaware jurisprudence has developed several anti-profiteering rules that protect corporate shareholders and corporations.³³ In general, a director can take

²⁶ Gevurtz F., *op. cit.*, p. 4.

²⁷ Hill C. A., & Painter R. W., *op. cit.*, p.1654.

²⁸ Hill C. A., & Mcdonnell B.H. "Disney, Good faith and Structural Bias". *Journal of Corporation Law*, vol. 32, no. 4, p. 845.

²⁹ Gevurtz F., *op. cit.*, p. 5.

³⁰ *Ibid.*

³¹ Hill C. A., & Painter R. W., *op. cit.*, p.1637. See also Gevurtz F., *op. cit.*, p. 382-407.

³² *Ibid.* p.1652-1653.

³³ Tsertsvadze L., *Duties of directors, according to US (State Delaware) corporate law and corporate law of Georgia (Comparative Analysis)*. Max-Planck-Institut für ausländisches und internationales Privatrecht,

advantage of corporate opportunities if the corporation, after being made aware of these business opportunities, has refused to use them. In *Guth v. Loft Inc.*,³⁴ the Delaware Supreme Court held that the doctrine of corporate opportunity is a reflection of the directors' duty of loyalty to the corporation. Under these conditions, the director cannot use the opportunities of the corporation for personal gain, in case the director knows that the corporation has sufficient financial capacity to take advantage of these opportunities for its benefit.³⁵

If the Court assesses that the opportunity belonged to the corporation, the beneficial director must transfer to the corporation all the benefits he received from the use of these opportunities for personal interests.³⁶ Referring to the doctrine of corporate opportunity, directors are obligated to act in the best interest of the company. Directors who become aware of an opportunity should not consider it valuable for personal interests, but only for the corporation. No member may pursue personal interests or use corporate opportunities for personal gain.³⁷

However, this obligation of directors is not absolute. For example, the director of the corporation may use the business opportunity offered to him for personal interests if the opportunity is not essential and in the interest of the corporation, based on its field of activity.³⁸

One of the most difficult cases involving two competing interests was the government-orchestrated merger of Merrill Lynch and Bank of America in 2008³⁹ The deal was not profitable for Bank of America shareholders, as the bank's management clearly misrepresented the facts about Merrill's financial situation to its shareholders. The state's Treasury Department exerted tremendous pressure on the bank's management to close the merger agreement at all costs.⁴⁰

Meanwhile the shareholders of Bank of America were interested in the value of the investment and in maintaining confidence in the financial system of the country. The Securities and Exchange Commission (SEC) filed a lawsuit for damages against the Bank of America board of directors regarding the decision.⁴¹ This legal conflict was resolved through an agreement of the parties, based on which the board of directors compensated the shareholders with the amount of 150,000,000 dollars.⁴²

Mittelweg 187, Hamburg, 2012, p. 28.

³⁴ *Guth vs. Loft Inc.*, 5A 2d. 503, Delaware, date 11.4.1939. Available online at <https://www.westlawinternational.com/>, last access on November 2nd, 2023.

³⁵ Jugeli G., *Protection of Capital in Joint Stock Company*. Tbilisi, 2010. p.171.

³⁶ *Ibid.*

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ Hill C. A., & Painter R. W. *op. cit.*, p.1637. For a more detailed description of the events that led to the merger of the corporation, see Letter from Andrew Cuvo, Attorney Ge., N.Y., to Senator Christopher Dodd, Chairman, Senate Comm. On Banking, Housing & Urban Affairs, 23.4.2009. Available online at <http://online.wsj.com/public/resources/documents/BofAmergLetter-Cuomo4232009.pdf>. p. 2-4, last access on 4. 11. 2023.

⁴⁰ *Ibid.*

⁴¹ Hill C. A., & Painter R. W., *op. cit.*, p.1660. See SEC vs. Bank of Am. Corp., Nos. 09 Civ. 6829, 10 Civ. 0215 (S.D.N.Y., 12.1.2010).

⁴² Story L., "Bank's Deal with SEC Is Approved". New York Times, WLN 3771779. 2010, p. 3.

Referring to the above case, the American doctrine has stated that the members of the board of directors are often in difficult position in making decisions, due to the influence of personal or professional connections with third parties. Also, these decisions, despite the impact, have not always put the legitimate interests of corporations at risk.⁴³

In most cases, it has led to difficulties in distinguishing between decisions of boards of directors that appear to favor legitimate interests but actually do not, and vice versa.

Despite these difficulties, the general rule in USA is to respect the business judgment rule of the board of directors, unless there exists a clear conflict, bad faith, or in some cases a lack of notice or disclosure of relevant information, such as e.g., in the case of Bank of America.⁴⁴ As a result of the respect for the judgment of the directors, the decisions of the board of directors that will be opposed, in most cases will remain in force and will be considered fair.⁴⁵

4. Conclusion

Through the analysis of the standards of disciplinary conduct for corporate directors in the US perspective, results that the American legislator has gone beyond defining the basic parameters, which regulate the conflict of interest and the prohibition of competition, offering a broad treatment of these standards of disciplinary conduct of the corporate director.

Both legislation and American doctrine have addressed the legal notion of conflict of interest, linking it to the existence of the administrator's material interest in the agreements with the corporation. Also, the legal protection of these transactions was provided with the approval of the shareholders or the board of directors.

American jurisprudence has maintained a distant position regarding the review of management decisions, respecting business judgment rule if the majority of independent directors had given approval for these transactions, reacting only in cases of the existence of a clear conflict or a display of bad faith or in some specific cases such as the lack of notification or disclosure of relevant information.

In the last decade, both doctrine and American jurisprudence have emphasized the independence of board of directors, which should not be defined by reference to some relationship, such as close kinship or a business partnership or contractual relations but should exist in essence.

Regarding the prohibition of benefiting from corporate opportunities, American jurisprudence has defined liberal rules, allowing directors to benefit only in the event of their rejection by the corporation, otherwise, the beneficial director must transfer them to the corporation all the benefits he received from the use of these opportunities for personal interests.

⁴³ Kaal W., & Painter R. "Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States". 40 Seton Hall Law Review, 2010, p. 1459.

⁴⁴ Hill C. A., & Painter R. W., *op. cit.*, p.1637.

⁴⁵ Kaal W., & Painter R., *op. cit.*, p. 1461.

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