The Fiduciary Duties of Directors of For-Profit Corporations

Corporate Director Standards of Conduct

Directors have broad obligations to act in the corporation's best interests, principally for the benefit of the owners of the corporation. The North Carolina Business Corporation Act ("Act") governs the actions of directors of North Carolina corporations and sets forth the duties a director must follow in serving on such a board. The Act balances the need to allow directors enough authority and discretion to manage the corporation's business against the need to hold directors accountable for wrongdoing or mismanagement. In general, the Act requires a director to act: (a) in good faith, (b) with due care, and (c) with loyalty.

Duty of Good Faith

The most general obligation of a director is the duty of acting in good faith. This requires a director to always discharge the responsibilities of the office of director honestly, conscientiously, and fairly. It also requires a director to make decisions for the corporation that are in the best interests of all the corporation's shareholders and not for the advantage or benefit of one group over another.

Often a director is put in the position of having to deliver bad news to, or deny information requests from, shareholders of the corporation. Such actions may lead the shareholders to form an unfavorable opinion of the director delivering the message. As a result, a director might be tempted to avoid or delay informing the shareholders or even to mislead the shareholders, about such news or action in order to avoid falling out of favor with or upsetting them. However, avoiding or delaying an unfavorable message or providing misleading information violates the director's duty of good faith.

Another common violation of the statutorily-required duty of good faith occurs when a director lets personality conflicts, or even the avoidance of such conflicts, get in the way of advising the corporation in a conscientious manner. Unproductive debate or personality clashes at meetings can lead to discord among the directors and decisions being made that are not in the best interests of the corporation as an entity. On the other hand, a director is not acting in good faith if the director allows avoidance of conflicts to control the director's actions. Not every vote needs to be unanimous and sometimes the initial lone dissenter ultimately sways a board's decision by pointing out previously overlooked problems or dangers flowing from the "law of unintended consequences."

Duty of Due Care

Good faith alone is not the limit of a director's obligation to the corporation. In addition, directors are under
an affirmative duty to direct and supervise the affairs of the corporation with diligence and care. Directors are not allowed to passively stick their heads in the sand, turn a blind eye, or simply refrain from misconduct in order to fulfill their duty of due care.

The Act defines the duty of due care as the obligation of a director to act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." However, if a director has a specialized background, the director's actions may be judged in light of that specialized background to determine whether that director complied not only with what an ordinarily prudent person would have done in the same situation but also with what one possessing and using the specialized background and knowledge of the director in question would have done. For example, a director who is a CPA and who is reviewing the corporation's financial records or a director who is a lawyer and who is reviewing a contract on behalf of the corporation each might be held to a higher standard of care than a non-CPA or non-lawyer director performing the same duties.

Moreover, the obligation to act with due care requires directors to make "responsible inquiries" to inform themselves as to the condition of the corporation and the conduct of the corporation's affairs. It is no excuse for directors to say that they had no knowledge of mismanagement or fraud if reasonable attention to facts or a reasonable inquiry into the affairs of the corporation would have disclosed such mismanagement or fraud. In essence, the duty of responsible inquiry requires directors to diligently monitor and reasonably investigate the ongoing operations of the corporation and to ask questions when making decisions.

**Duty of Loyalty**

The Act codifies the duty of loyalty by requiring a director to act "in a manner [the director] reasonably believes to be in the best interests of the corporation." In effect, a director must act on behalf of the corporation, and the director's actions must be guided by the best interests of the corporation and the corporation's mission and goals. For example, a director's use of the corporate governance machinery or assets to protect the director's incumbency constitutes a violation of the director's duty of loyalty, because it diverts ultimate control from the shareholders to the director and may prevent the shareholders from exercising their prerogative to elect a different director while at the same time expending corporate funds for a non-business related purpose.

This duty also prohibits a director from using the position for the director's own personal gain and to the detriment of the corporation. For example, a corporation may solicit bids for the construction of a new facility at a time when one of its directors owns a construction company. If that director uses the director's board membership to gain access to information or bids received from other construction companies in order to submit a lower bid on behalf of the director's company, the director has breached the duty of loyalty to the corporation by using the corporation's private information for the director's personal gain. This breach is not cured by the submission of the lowest bid. The breach was the use of the information. Besides, if the director had not used the inside information to formulate a bid, the bid from the director's construction company may have been even lower to the benefit of the corporation.

The duty of loyalty, however, does not preclude all transactions between a director and the corporation, even ones that unquestionably benefit the director personally. Certain transactions between a director and the corporation are permissible as long as: (a) such transaction is fair to the corporation, (b) the conflict is disclosed, and (c) all interested directors refrain from participating in the deliberations and votes regarding such transaction. In the above example, if the director who owned the construction company had submitted the bid without prior knowledge of the other bid amounts, had disclosed the director's interest in the construction company to all other board members, and had refrained from participating in any discussions or votes regarding the bid process, the acceptance of the director's company's bid by the remaining board
members would not be a breach of the director's duty of loyalty.

**A Director Doesn't Have to Be "Right"**

Despite the duties discussed above, it is important to understand that the Act focuses on the manner in which a director performs the director's duties on behalf of the corporation, rather than on the correctness or ultimate result of the director's decisions. Simply put, the Act provides that a director will not be personally liable for any action or inaction as a director, whether the result turns out to be good or bad for the corporation, so long as the director has performed the duties of director in compliance with the above standards of conduct.

**Summary**

Being the director of a corporation is serious business. Merely possessing a pure heart and acting with good intentions do not relieve a director from obeying the fiduciary obligations of acting in good faith, with due care, and with loyalty.

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