

Other Articles

WRONGFUL OMISSIONS BY CORPORATE DIRECTORS: *STONE V. RITTER* AND ADAPTING THE PROCESS MODEL OF THE DELAWARE BUSINESS JUDGMENT RULE

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When should corporate directors be liable to shareholders for omitting to take a corporate action?¹ The question usually arises when subordinate corporate employees have engaged in serious wrongdoing, either looting the corporation or breaking the law and subjecting the corporation to liability, and the directors have not detected and stopped the wrongdoing.² Conceivably, the question could also arise if a shareholder alleged that directors wrongfully failed to have the corporation exploit a particularly lucrative business opportunity. In either case, the shareholder's claim is

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1. See generally, J.F. Rydstrom, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R.3d 941 (1969).

2. E.g., *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (addressing suit by shareholder seeking to hold directors of bank liable for failure to detect and prevent employees of bank from violating federal Bank Secrecy Act); *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. 1996) (assessing the claim of a shareholder seeking to hold directors liable for not detecting and stopping employees from entering contracts that violated federal Medicaid laws); *ATR-Kim Eng Fin. Corp. v. Araneta*, No. 489-N, 2006 Del. Ch. LEXIS 215 (Del. Ch. Dec. 21, 2006) (finding corporate directors liable for failing to detect and prevent controlling shareholder from transferring substantially all corporate assets to members of his own family for no consideration); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (holding a director liable for failing to detect and stop officers from converting funds held in trust by corporation).

that directors should be liable for their mere omissions—not for considering an action and then deciding not to act, but for failing even to consider acting at all. Perhaps unsurprisingly, plaintiffs have found such cases exceedingly difficult to win. Indeed, in *Stone v. Ritter*, the Delaware Supreme Court quoted Chancellor Allen as saying that such claims represent “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”³

But if the cases have proved difficult for plaintiffs, they have also proved difficult for courts, for courts have found it very hard to articulate a legal standard to govern such cases. In one sense, the question of when directors should be liable for their mere omissions admits of a deceptively simple answer: wrongful omissions should be treated no worse and no better than wrongful decisions deliberately undertaken. Put another way, the standard for wrongfulness for omissions should be the same as the standard of wrongfulness for deliberate decisions. Such a view seems sensible because there is no obvious reason to treat wrongful omissions more or less harshly than wrongful decisions. Moreover, the essence of the claim is—in some form or other—negligence,⁴ and the standard economic analysis of negligence does not distinguish between active and passive conduct. Whether active or passive in a causal sense, a party is negligent in the economic interpretation of negligence if the party could have modified its conduct at a cost less than the expected cost of the accident.⁵ It seems, therefore, that corporate law similarly ought to make no distinction between directors who make a deliberate decision harmful to the corporation and directors who fail to act when they should have in order to prevent harm to the corporation.

Asking about the liability of directors to their corporation naturally brings us to the business judgment rule. The business judgment rule, as developed in Delaware, however, makes it impossible to treat wrongful omissions by directors on par with their wrongful decisions. The reason is that, generally speaking, the Delaware rule does not apply a standard to evaluate the substance of decisions by corporate directors; it inquires, rather, into the process of directorial decision-making. As Chancellor

3. *Stone*, 911 A.2d at 372 (quoting *Caremark*, 698 A.2d at 967).

4. *But see* FRANK H. EASTERBROOK & DANIEL FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 93 (1991) (contrasting courts’ usual approach in negligence cases with their application of the business judgment rule and stating that in such cases “that there is a specially deferential approach.”); *id.* at 103 (describing duty of care cases under business judgment rule as involving “detect[ing] negligence”).

5. Similarly, when two parties are involved in an accident, what matters from an economic point of view is not which party was active and which passive in a colloquial sense, but which party could modify its conduct at a lower cost—that is, which party was the cheaper cost avoider. *E.g.*, RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 51 (7th ed. 2007).

Allen put it in a famous case related to wrongful omissions by directors, the court's review of a board decision under the business judgment rule is not "determined by reference to the content of the board's decision that leads to a corporate loss" but by "the good faith or rationality of the process employed" in making the decision.⁶ In particular, the court asks whether the directors were fully informed, disinterested and independent; and, if they were, whether at the conclusion of their deliberations they honestly believed that the decision they were making was in the best interest of the corporation, understanding such interest as being the maximization of shareholder value. If fully informed, disinterested and independent directors honestly thought their decision was in the best interests of the company, then the court will limit its substantive review of the challenged decision to the issue of whether the decision can be attributed to any rational business purpose—a standard so easily satisfied in practice that directors are virtually never found to have violated it.⁷ In short, with this limited exception concerning a rational business purpose, the Delaware business judgment rule is concerned with process only. Hence, in the case of mere omissions—cases where directors did nothing at all when they should have been doing something—there is no process of decision-making to evaluate because there was no decision at all. Hence, whatever it merits in other contexts, the Delaware business judgment rule is inapplicable even in principle to mere omissions by directors.⁸

Although not expressly recognized by courts in these terms, this

6. *Caremark*, 698 A.2d at 967 (emphasis omitted).

7. If the court finds that the directors were not fully informed, disinterested and independent, then the court will shift the burden of proof to the defendant directors to prove that the challenged transaction was entirely fair to the corporation and its shareholders—a standard corporate directors often find difficult to meet. As explained more fully below, the rule thus creates strong incentives for directors to use impeccable process in making business decisions and rewards such process by effectively insulating decisions made with such process from substantive review.

8. This result has been acknowledged implicitly in the case law and explicitly in the scholarly literature. See J. F. Rydstrom, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R.3d 941 (1969); Stephen Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 99 (2004) ("It is well established, for example, that directors may only invoke the business judgment rule when they have made a conscious decision. Hence, the business judgment rule does not prevent judicial review of a board's failure to exercise proper oversight of the corporation's management."). When directors are aware of a potential course of action, deliberate about it, and choose not to act (I shall call such cases *deliberate omissions*), the process-based business judgment rule can be applied as usual. That is not the situation at issue here. In cases of what I shall call *mere omissions* (or simply *omissions*), the claim is that directors should have taken some action that the directors never even considered taking, generally because they were not even aware of the facts that would lead someone to consider taking such action (e.g., directors may utterly fail to act to prevent employees from breaking the law because they are entirely unaware of the employees' criminal acts).

circumstance led courts faced with suits based on mere omissions by directors to follow one of two paths. In some cases, courts have announced what seem to be *per se* rules to the effect that there are some things, such as the contents of a corporation's organizational documents or financial statements, which all directors are required to know in all circumstances.⁹ Usually, such rules have been announced in finding directors liable who have grossly breached their obligations by utterly failing to manage the corporation. These rules are good as far as they go, but it seems clear that directors should be held to a standard higher than the minimum elaborated in such *per se* rules. Such rules cannot exhaust the universe of information that directors should have before them.

Furthermore, although there are some things that any director of any corporation should know about the corporation, corporations are often as different from one another as human beings are, and so for each corporation; there may be special issues particular to it about which directors should be informed. Some corporations, for example, may have significant compliance or antitrust issues that other corporations can safely ignore. Implicitly recognizing this fact, courts in other cases have considered on an *ad hoc* basis whether directors *should have known* about particular facts or circumstances of which they were ignorant and which would presumably have led them to act (e.g., that subordinate employees were engaged in criminal conduct) had they known of them. Although the conclusions reached in these cases are often convincing, their *ad hoc* nature has prevented such cases from developing into a coherent body of law.¹⁰

Against this background, Chancellor Allen in 1996 decided *In re Caremark Int'l Inc. Deriv. Litig.* and held that corporate directors would be liable for failing to know about wrongdoing by subordinate employees only if they were guilty of "such an utter failure to attempt to assure a reasonable information and reporting system exists" as would establish a lack of good faith.¹¹ Last year, the Delaware Supreme Court endorsed and elaborated this standard in *Stone v. Ritter*.¹² The law in Delaware now is that directors may be liable for their mere omissions only if *either* the directors utterly fail to implement a reporting and information system knowing that they should have done so, *or*, having implemented such a system, they consciously failed to monitor or oversee its operations.¹³

9. *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (requiring directors to be familiar with contents of organizational documents, attend meetings, have rudimentary understanding of business of corporation).

10. *See Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963) (detailing a particularized inquiry on case-specific facts about whether board should have known that subordinate employees were causing corporation to violate antitrust laws).

11. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. 1996).

12. *See Stone v. Ritter*, 911 A.2d 362, 362 (Del. 2006).

13. *See id.* at 370.

Knowing wrongdoing is a component of either prong. This rule side-steps the problem of adapting the process-based business judgment rule to director omissions: in lieu of an inquiry into process, we get an inquiry into *mens rea*. What becomes legally relevant is nothing related to the process of directorial decision-making except whether the directors *knowingly* failed to do their duty. *Stone v. Ritter* thus creates a strange disparity between negligently made decisions and negligently occurring omissions, for in the latter case the plaintiff must also show conscious disregard for duty.

The premise of this article is that the Delaware business judgment rule is founded on powerful arguments concerning institutional competence and economic efficiency,¹⁴ and that it should, to the extent possible, be adapted to cover the case of wrongful director omissions. I argue below that this goal can be attained and thus the Delaware Supreme Court's retreat from the process-based model in *Stone v. Ritter* is unnecessary. In developing this argument, I begin in Part I by reviewing how the Delaware rule governs decisions by the board, noting some of the reasons that make this rule an especially good one and culling from the rule the elements that ought to be assembled into a rule adapted to director omissions. In particular, I argue that another holding in *Stone v. Ritter*, that the duty of good faith should be seen as a subpart of the duty of loyalty, is a conceptual mistake that needs to be sorted out in order to see clearly how the business judgment rule should function. In Part II, I consider in greater detail some of the earlier cases on director omissions and discuss how *Caremark* and *Stone v. Ritter* significantly improved on them. Much of what courts have said in all these cases is valuable, however, and should be included in adapting the Delaware rule to cover director omissions. In Part III, I set out a version of the Delaware rule adapted to the case of director omissions. I then argue, first, that the proposed adaptation of the rule fully serves the policy objectives that underlie the process model of the business judgment rule, is more protective of shareholder interests than the rule embodied in *Stone*, and nevertheless in no way substitutes a court's judgment for that of a board on business matters. In Part IV, I make some brief concluding observations.

14. It is impossible to discuss the merits of the Delaware law of fiduciary duties without alluding to the fruitless argument about whether Delaware's law is a product of a race-to-the-bottom or a race-to-the-top—i.e., whether the law has evolved to please directors by shielding them from liability or to please shareholders by maximizing shareholder value. Compare William L. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L.J. 663 (1974) (arguing for the race-to-the-bottom position), with Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing for the race-to-the-top position). Compare both of these arguments with those in Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) and Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005).

I. THE DELAWARE BUSINESS JUDGMENT RULE: CARE, LOYALTY AND GOOD FAITH, THE CONFUSION IN *STONE*, AND A THEORETICAL JUSTIFICATION FOR THE RULE

In this Part, I shall (a) review the components of the Delaware business judgment rule with special attention to the relationship among the duties of loyalty and good faith as articulated in *Disney* and *Stone*, and (b) propose a general theory underlying the rule that will serve as a guide in subsequent sections to adapting the rule to cover the case of wrongful director omissions.

A. *Review of the Delaware Business Judgment Rule*

The Delaware business judgment rule is in reality a complex set of related rules. To begin with, a plaintiff shareholder¹⁵ of a Delaware corporation challenging a business decision by the board of directors first has the burden of showing that a majority of the directors making the decision each breached one or more of three fiduciary duties: the duty of care, the duty of loyalty or the duty of good faith.¹⁶ All three of these duties are unfortunately named because duties quite different in content but bearing identical names are well-known from the law of agency.¹⁷ In agency law, violations of these fiduciary duties generally make an agent liable to its principal in damages. In Delaware corporate law, however, the effect of violating the duties is not necessarily to make directors liable, either to shareholders or the corporation. Rather, in Delaware corporate law, a director's observation of these duties contributes to a process of decision-making that justifies the belief that the result of such process is, in

15. For the sake of simplicity, I am assuming here that the action is a direct, rather than a derivative action. For the most part, this assumption does not matter to my analysis; where it does matter, I shall note the distinction in the text.

16. The usual judicial language used to express this idea involves quoting *Aronson v. Lewis* for the proposition that the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." 473 A.2d 805, 812 (Del. 1984). It seems clear that one of these elements—acting on an informed basis—clearly corresponds to the duty of care. Courts generally fail to explain, however, how the other two elements—acting in good faith and acting in the honest belief that the action taken was in the best interest of the corporation—match up with the recognized duties of loyalty and good faith. If this question really needs to be answered, for reasons that will become apparent from the discussion of good faith in the text below, I would adopt the verbally awkward solution of saying that "good faith" in *Aronson* refers to the duty of loyalty (which otherwise seems not to be mentioned) and the "honest belief" language refers to the duty of good faith.

17. See RESTATEMENT (SECOND) OF AGENCY § 379 (1958) (stating the duty of care and skill); *id.* at § 387 (providing the general principle of duty of loyalty, etc.).

all human probability, as good a result as could be had under the circumstances. Good process, in other words, is a proxy for good substance. Hence, a violation of one of these duties compromises that process and destroys the basis for believing that the result of the process is likely to be a good one. Violation of these duties does not, without more, make the directors liable to anyone.¹⁸

In particular, the director's duty of care is a requirement that the director be informed of all material facts reasonably available to the director and related to the decision to be taken.¹⁹ This standard (or, more precisely, the words *material* and *reasonably* as used therein) is understood in a gross negligence sense:²⁰ for the duty of care to be violated, the director must have neglected to consider very relevant information that was easily available.²¹ In *Smith v. Van Gorkom*, for example, the Delaware Supreme Court found that a board considering a sale of the company had breached its duty of care because it failed to obtain a financial study of the intrinsic value of the company—a kind of study that could have been produced in a couple of days by the company's financial advisors or even its in-house financial professionals.²² The reason underlying the duty of care requirement, obviously enough, is that decisions made without the benefit of reasonably available material information are much more likely

18. Delaware courts occasionally speak cryptically about the opposite possibility, but the cases are all as I describe in the text. See, e.g., *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 46 (Del. 2006) (contrasting violations of fiduciary duty that would deprive directors of protection of business judgment rule with violations that would make them "directly liable").

19. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

20. *Id.* at 873.

21. As Easterbrook and Fischel note, if we interpret the duty of care in economic terms, the idea is that directors should gather all the information that is *worth* gathering, i.e., they should gather information until the marginal cost of gathering more would exceed the benefit of having such additional information in making the decision at issue—and this, as Easterbrook and Fischel point out, is itself a business. EASTERBROOK & FISCHEL, *supra* note 4, at 93, 107-108 (1991). When a court thus determines *ex post* whether a board gathered all the material information reasonably available, it is thus intruding on the business judgment of the board. The justification for this, in my view, is that costs of gathering the information are usually exceedingly small, and so there is little worry that shareholders will suffer much if boards (looking over their shoulders at courts) gather too much rather than too little information before making a business decision.

22. See *id.* at 873. Commentators who still argue that the Trans Union board in *Van Gorkom* was not grossly negligent miss the point. It is not as if there is an independently accessible meaning of the phrase "grossly negligent" that can be applied to the facts of the case to determine whether the Trans Union directors were "grossly negligent." That was true back in 1985, but now that *Smith v. Van Gorkom* is settled law (and, indeed, unquestioned doctrine in Delaware law), the meaning of the phrase "gross negligence" has changed so that the behavior of the Trans Union board is now a paradigm case of gross negligence by a corporate board.

to be erroneous than are informed decisions.²³

A director's duty of loyalty is a requirement that the director be free from certain kinds of conflicts of interest related to the decision at issue that would tend to impair the director's business judgment and so support the conclusion that the director's judgment is, if not unsound, at least not worthy of trust. In particular, a director breaches the duty of loyalty if the director is either *interested* in the transaction being approved or lacks *independence*. A director is interested either when the director appears on both sides of the transaction or

when (1) a director personally receives a benefit (or suffers a detriment), (2) as a result of, or from, the challenged transaction, (3) which is not generally shared with (or suffered by) the other shareholders of his corporation, and (4) that benefit (or detriment) is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders.²⁴

A director's *interestedness* is relative to a transaction; hence, a director may be interested in one transaction but not in another. Clearly, breaches of the duty of loyalty render a director's decisions suspect. We do not trust the judgment of an interested director for the same reason that we think no one should be a judge in his own cause.

A director lacks independence when the director is *controlled* by another party, that is, either when the director is *dominated* "by that other party, whether through close personal or familial relationship or through force of will," or when the director is *beholden* to the other party because

23. *Smith v. Van Gorkom* and its rule requiring that directors be informed of all material facts reasonably available before making a business decision has been roundly criticized. For example, Easterbrook and Fischel say that the duty to be informed is "anomalous," see EASTERBROOK & FISCHEL, *supra* note 4, at 107. They argue that "[j]udicial inquiry into the amount of information managers should acquire before deciding creates the precise difficulties that the business judgment rule is designed to avoid," *id.*, namely, the costs of erroneous judicial determinations of disputes with little or no corresponding benefits for shareholders. "The ultimate issue is who should decide how much information to acquire in advance of a business decision. Allowing shareholders to challenge business decisions that they say were not 'informed' has the effect of substituting the business judgment of some shareholders, their attorneys, and a court for that of the managers." *Id.* at 108. This assumes, however, that the question of which information it is efficient to consider before making a business decision is as difficult as the question of which substantive business decision to make in the circumstances. The theory of this article is that questions of process—in which I include questions of which information it is efficient to consider prior to making a business decision—can be determined at significantly lower cost and with lower error rates than can substantive business judgments. Indeed, such seems to me to be the fundamental premise underlying the process model of the Delaware business judgment rule.

24. *Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002).

the controlling party

has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively.²⁵

Just as we do not trust the judgment of an interested director, neither do we trust the judgment of a director who is controlled or lacking in independence: the judgment of such directors is too likely to be swayed by factors unrelated to the merits of the matter at hand, too likely to be swayed through love or fear of the controlling party. Though minutely elaborated, the point of the rules regarding director interest and independence is clear: if a director has a conflict of interest related to a transaction, then the director's judgment about that transaction cannot be trusted.²⁶

If, however, a board of directors is fully informed and is free of conflicts of interest and thus there has been no breach of either its duty of care or its duty of loyalty, then there remains the question of what, as a result of such process, the board honestly believes is in the best interests of the corporation, understanding that interest to be the maximization of shareholder value in accordance with the law. This, in my view, is the proper province of the duty of good faith. That is, the board acts in good faith if it acts in accordance with its "honest belief that the action taken was in the best interest of the company."²⁷ If the board acts contrary to its honest belief about what is in the best interests of the corporation, or if it simply fails to act when its honest belief is that action is required to serve that interest, then it breaches its duty of good faith. If the board's honest belief arises from an impeccable decision-making process (i.e., an informed process free from conflicts of interest), then the board is entitled to the protection of the business judgment rule. The duty of good faith is, as it were, the subjective capstone to an objectively good process.

Whether this explanation of the duty of good faith is a correct statement of the law in Delaware at the moment is, however, unclear. Prior to *Disney*, the proper province of the duty of good faith and its relationship to the other duties was "not a well-developed area of [Delaware] corporate

25. *Id.*

26. Throughout this article I shall use the terms *interested*, *independent*, *controlled*, *dominated*, and *beholden* (and their various cognate forms) in the technical senses given here. As shorthand for the idea that a director is *disinterested* with respect to a transaction and independent, I shall say that a director is free from conflicts of interest.

27. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

fiduciary law”²⁸ and hence was much-discussed in the scholarly literature.²⁹ In *Disney* the Delaware Supreme Court attempted to remedy this situation and provide “some conceptual guidance to the corporate community.”³⁰ Rather than just saying what the duty of good faith required, however, the *Disney* court took a more limited approach. In particular, it pointed out two categories of actions that would constitute *bad faith*: first, “fiduciary conduct motivated by an actual intent to do harm,”³¹ which is “classic, quintessential bad faith,”³² and, second, “intentional dereliction of duty, a conscious disregard for one’s responsibilities.”³³ Although the court denominated the first kind of actions “subjective bad faith,”³⁴ this description is unhelpful because the second kind of conduct is likewise characterized by a subjective component.

This holding from *Disney* is clearly not logically equivalent to the explanation of the duty of good faith I gave above. It becomes equivalent, however, if we make two additional assumptions. First, we would have to assume that the two categories of bad faith actions that the court identified exhaust the category of bad faith. Although the court left open the possibility that there might be other categories of such actions,³⁵ it is highly unclear what they might be, and so this assumption is a reasonable one to make.³⁶ Second, because the court chose without explanation to discuss conduct in *bad faith* rather than conduct in *good faith*, we would have to assume that actions not in bad faith count as actions in good faith, i.e., that there is not a third possibility of actions in neither good faith nor in bad faith. This too seems like a reasonable assumption because either a board

28. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 63 (Del. 2006).

29. Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2005); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456 (2004).

30. *In re Walt Disney*, 906 A.2d at 64 (Del. 2006).

31. *Id.*

32. *Id.*

33. *Id.* at 66.

34. *Id.* at 64.

35. *See id.* at 67 (“To engage in an effort to craft . . . a definitive and categorical definition of the universe of acts that would constitute bad faith would be unwise and is unnecessary to dispose of the issues presented on this appeal.”) (internal quotation omitted).

36. Quoting the Chancery opinion below, the court refers to instances in which “the fiduciary acts with the intent to violate applicable positive law” as such a possibility. *Id.* at 67. This, however, is not an exception to the statement in the text. The duty of good faith requires that the director believe that the contemplated action is in the best interests of the corporation—meaning that it maximizes shareholder value *in accordance with the law*. Hence, no corporate action that violates positive law could ever be in the best interests of the corporation. Corporations exist to make money *legally*, not in any way whatsoever.

honestly believes a course of action maximizes shareholder value in accordance with the law or else it does not (including in this second alternative both cases in which the board believes that the course of action does *not* maximize value and cases in which the board simply has no opinion). Given these two assumptions, the holding in *Disney* logically entails the explanation of the duty of good faith I have given here.

Unfortunately, the court complicated and probably threw this neat doctrine into confusion in *Stone*. There, Justice Holland, writing for the court, stated that

although good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.³⁷

The reason, according to Justice Holland, is that the duty of good faith is part of the duty of loyalty. He writes, “the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.”³⁸

The motivation for thus making the duty of good faith a subpart of the duty of loyalty should be reasonably clear. If the two were independent, it would be possible to act loyally but not in good faith or to act in good faith but not loyally—and those results seem, at least from a linguistic point of view, very odd. Justice Holland acknowledges that it is possible to act in good faith but be subject to a conflict of interest—that is, in good faith but not “loyally”—but apparently the idea that a director could act not in good faith but nevertheless “loyally” is too jarring. Hence, Justice Holland wants to say that any director acting not in good faith must be breaching the duty of loyalty.

This is to let semantics obscure doctrine. From an analytical point of view, it is obvious that a director deliberating about a transaction in connection with which he or she is subject to a conflict of interest can nevertheless reach an honest belief that the transaction is in the best interests of the corporation and then act accordingly. This might be the case even when the director recognizes that he or she personally benefits from the transaction.³⁹ On the other hand, it is equally obvious that a director deliberating about a transaction in connection with which he or she is *not* subject to a conflict of interest can nevertheless choose to act *not* in

37. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (citation omitted).

38. *Id.*

39. *E.g.*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976).

accordance with his or her honest belief about whether the transaction is in the best interests of the corporation. Such cases would be rare, because usually when directors choose to act contrary to their honest beliefs about what is best for the company, they are doing so in order to benefit themselves or someone by whom they are controlled. But, while this is generally the case, it is not always necessarily so. A director could act contrary to his or her honest belief about what maximizes shareholder value out of political or ideological motives, out of personal hostility to the chief executive officer, or just in a fit of pique. Hence, since we have here two different kinds of problems with directorial decision-making, it helps immensely to have two different names for these problems. The phrases *duty of loyalty* and *duty of good faith* will do as well as any other terms.

It is true that this nomenclature allows the semantically odd result that a director can act loyally but not in good faith, as well as in good faith but not loyally—or, equivalently, disloyally but in good faith as well as loyally but in bad faith—but such linguistic curiosities hardly matter. This is a technical area of law where words have technical meanings. To insist that any director who acts in bad faith also acts disloyally, but then explain that this is a distinct kind of disloyalty, different from the conflicts of interest that are the usual subject of loyalty inquiries under the business judgment rule, does not represent a doctrinal advance. It is a semantic accommodation that obfuscates rather than illuminates.

Happily, this semantic accommodation in *Stone* probably makes no real difference. We can regard the duty of loyalty as related solely to conflicts of interest and the duty of good faith as related solely to the state of mind of the director (as is my view), or we can regard the duty of loyalty as having two distinct components, one of which concerns conflicts of interest and has nothing to do with the director's state of mind and one of which concerns the director's state of mind and has nothing to do with conflicts of interest. Either way, the results of applying the business judgment rule will be the same. Together, care, loyalty, and good faith form a coherent whole. The duty of care ensures that directors are informed about what they are deciding on, and the duty of loyalty (or its conflicts-of-interest component) ensures that they have no conflicts of interest. These two duties together guarantee the integrity of the decision-making process. The duty of good faith (or the good-faith component of the duty of loyalty) applies to the result of that process, that is, to the director's honest belief arising from the process as to what is in the best interests of the corporation. A business judgment reached under conditions in which all duties have been observed is the honest belief of informed decision makers free from conflicts of interest. The three duties each has its proper place in supporting the conclusion that a board's business judgment is likely to be sound, and any can be breached without breaching

either of the other two.⁴⁰

The Delaware business judgment rule does not, however, stop there. If a majority of the directors have observed their duties of care, loyalty, and good faith, then the court will conduct a substantive inquiry concerning the challenged business decision limited to whether the decision serves any rational business purpose, i.e., is connected in any rational way with maximizing shareholder value—a test that is virtually always satisfied.⁴¹ “To be sure,” the Delaware Supreme Court has said, “there are outer limits [beyond which corporate decisions made with good process will not be respected] but they are confined to unconscionable cases where directors irrationally squander or give away corporate assets.”⁴² In practice, the test is indistinguishable from that for corporate waste, i.e., “an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”⁴³ In recent years, the Delaware Supreme Court has virtually endorsed the idea that a business decision can be attributed to no rational business purpose if, and only if, it is also corporate waste.⁴⁴

On the other hand, if a majority of the directors have breached one or more of the duties of care, loyalty, and good faith, then the board is said to have lost the protection of the business judgment rule, and the burden of proof shifts to the defendant directors to prove that the challenged transaction was entirely fair to the corporation and its shareholders.⁴⁵ This

40. Some Delaware cases have, in dicta, expressly contradicted this assertion. *See, e.g.*, *Orman v. Cullman*, 794 A.2d 5, 14 n.3 (Del. Ch. 2002) (Chandler, C.) (stating that “the duty to act in ‘good faith’ is merely a subset of a director’s duty of loyalty”); *Emerald Partners v. Berlin*, No. 9700, 2001 WL 115340, at *25 n.63 (Del. Ch. 2001) (Jacobs, V.C.) (“Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or ‘subsidiary requirement’ that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.”). For the reasons given in the text, I think such dicta are simply mistaken. In particular, since it is clear that a director may breach the duty of loyalty (e.g., by being interested) without thereby breaching the duty of good faith (i.e., may, despite the conflict of interest, think that the action in question is in the best interests of the corporation), and conversely may breach the duty of good faith (by acting otherwise than to advance what he or she believes to be in the best interests of the company) without breaching the duty of loyalty (having a conflict of interest), there is no reason to assimilate these duties or to treat one as a subpart of the other.

41. *Cf.* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 *VAND. L. REV.* 83, 100 (2004) (“Even the reference to a rational business purpose requires only the possibility that the decision was actuated by a legitimate business reason, not that directors prove the existence of such a reason.”).

42. *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

43. *Id.* (quoting *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993)).

44. *Id.* at 264 (stating that “[i]rrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test”).

45. *See* *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

is a demanding standard that requires directors to prove that both the process and the price involved in the transaction were fair.⁴⁶ The inquiries into process and price are not separate inquiries, but aspects of one single inquiry of which the court will consider all relevant factors.⁴⁷ Boards do not always lose entire fairness inquiries,⁴⁸ but, both procedurally and substantively, boards facing entire fairness inquiries are in a very difficult position, and so they usually do lose.⁴⁹

The drastic difference between rational business purpose review and entire fairness review creates a powerful incentive for directors to use impeccable processes in making corporate decisions. In practice, directors can be virtually assured of prevailing if their decisions are reviewed under the rational business purpose test. On the other hand, the entire fairness standard is so onerous for corporate directors that defendants faced with an entire fairness review often move quickly to settle the plaintiffs' claims.⁵⁰ It would be an exaggeration, but not a gross one, to say that business judgment cases turn on the inquiry into whether the directors have used good processes in their decision-making, with the directors prevailing if they have and losing if they have not.⁵¹

B. Theory Underlying the Business Judgment Rule

What would justify this complex of rules known as the business judgment rule?⁵² The theory seems to be that the best possible protection

46. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

47. See *Van Gorkom*, 488 A.2d 858.

48. *E.g.*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976).

49. *E.g.*, *Van Gorkom* 488 A.2d 858; *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

50. *E.g.*, *In re Cox Commc'ns Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005) (noting that, in freeze-out contexts, when defendant parent corporation cannot prevail on motion to dismiss and so has burden of proving entire fairness, defendant usually moves quickly to settle).

51. In a variety of contexts, Delaware courts have noted that the standard of review of directors' actions tends to be outcome-determinative. The courts made this observation in connection with determining whether an anti-takeover device would be reviewed under the business judgment rule or the *Unocal* standard; since the difference in stringency between these two is much less than that between rational business purpose review and entire fairness, *a fortiori* the difference between these two tends even more strongly to determine outcomes of cases. See generally *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

52. Again, there is endless literature on this. See generally *Joy v. North*, 692 F.2d 880, 892 (2d Cir. 1982) (Opinion by Ralph Winter, J.) (pointing out that the basis of the business judgment rule is to encourage directors, who are more risk averse than shareholders, to make risky decisions); American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* §4.01 cmt. d (2008) (discussing that the business judgment rule protects directors from risk inherent in hindsight review of business decisions);

for shareholder interests in the long-run is the honest business judgment of informed business people free from conflicts of interest.

This is by no means an obvious conclusion, and buried in this theory are at least three related premises. The first concerns institutional competence: courts believe themselves competent to evaluate the quality of the board's decision-making process but not, generally speaking, the business merits of the decisions themselves. As Chancellor Allen put it in *Caremark*, "To employ a different rule—one that permitted an 'objective' evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests."⁵³

With respect to the competence of the court to evaluate the process of decision-making, there is little argument. Especially when it comes to the most troublesome issues of process—questions of directorial conflict of interest—courts are in their element, for detecting and analyzing conflicts of interest is paradigmatically a lawyerly task. It is thus no accident that, of the three fiduciary duties guarding the directorial decision-making process, the duty of loyalty has engendered by far the most litigation and the most highly-elaborated legal doctrine. By contrast, the Delaware courts started developing the duty of good faith only in the last couple of years in the *Disney* cases, and their duty of care jurisprudence has never progressed significantly beyond the *Smith v. Van Gorkom* rule that directors must be informed of all material facts reasonably available. Nor, it seems, could it do so, unless the Delaware courts were prepared to make broad substantive judgments about which matters directors ought to be informed when making certain classes of decisions.⁵⁴

As to the incompetence of courts to evaluate the substance of business decisions, although courts have been professing their incompetence in this

EASTERBROOK & FISCHER, *supra* note 4, at 90-108 (1991) (analyzing how courts review business decisions of corporate directors so leniently under the business judgment rule because, as repeat players, directors are effectively disciplined by capital and labor markets); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 53 VAND. L. REV. 82 (2004) (reviewing various rationales for business judgment rule, including discipline of capital and labor markets, encouragement of risk taking by directors, lack of business expertise on part of judges, and preservation of efficient internal board dynamics); Jeffrey N. Gordon, *What Enron Means for Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1245 (2002) (noting that directors and management are more risk averse than shareholders); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1491 (1984) (judges inexpert at business matters).

53. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

54. As noted above, such decisions really are business decisions, for if directors are to maximize shareholder value, they should gather information only to the point at which the marginal cost of doing so equals the marginal benefit thereof.

area for a long time,⁵⁵ scholars have generally not been convinced.⁵⁶ Here, I think, the courts have it right, and the scholars have it wrong. There are, of course, some obvious things to be said in support of the idea that courts will not make better business decisions than businesspeople. For one thing, people involved in the business tend to have accumulated background knowledge and experience that courts never will. For another, the skills and temperaments of lawyers and judges are generally different from those of successful businesspeople.⁵⁷ Lawyers and judges are trained to identify and plan for negative contingencies and are used to resolving disputes arising from such contingencies in litigation; they are thus likely to be more risk-averse than businesspeople. Finally, the individuals involved in the business often have large financial interests of their own at stake in the outcome, and such stakes, to borrow a phrase from Dr. Johnson, tend to concentrate the mind.

With all that said, however, there is significant warrant for the common scholarly unease with any rationale for the business judgment rule based on a court's lack of the specialized knowledge of businesspeople. Just as judges lack the specialized knowledge of businesspeople, so too do they lack the even more specialized knowledge of, say, doctors and engineers.⁵⁸ Courts are nevertheless perfectly prepared to apply substantive standards of negligence in professional malpractice cases, at least when assisted by expert testimony.⁵⁹ Any argument for the business judgment rule based on a supposed lack of expertise on the part of courts must, therefore, explain why courts are so much less competent at business matters than they are in other areas.

55. In *Dodge v. Ford Motor Co.*, the Michigan Supreme Court explained the rationale behind the business judgment rule in the now famous sentence, "The judges are not business experts." 170 N.W. 668, 684 (Mich. 1919).

56. Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 581 (determining that judges have more competence in business than in almost any other kind of case they decide); Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. 799, 826 (1997) (concluding rationale is clearly insufficient). *But see* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 118 (arguing for a version of the rationale based on cognitive psychology and behavioral economics).

56. *Cf.* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1491 (1984) (discussing thought patterns of judges and lawyers generally unsuited for making business decisions).

57. *Cf. id.*

58. *See, e.g.*, EASTERBROOK & FISCHER, *supra* note 4, at 94 (1991) (arguing that business judgment rule must rest on something more than judges' lack of specialized business knowledge because judges similarly lack specialized knowledge in other fields and nevertheless decide negligence cases in such fields).

59. Sometimes the standard is merely professional custom (as in medical malpractice in many jurisdictions) and sometimes the standard is that of substantive negligence.

There is, in fact, good reason to think they are just that. For, business decisions involve a degree of uncertainty so great that they differ in kind from decisions of other professionals like doctors and engineers. Such professionals deal in matters that, in the end, are questions of natural science. The issues are finally ones of biology, chemistry, and physics. There are, to be sure, always empirical uncertainties and other problems requiring judgment in the exercise of these professions, and there will be reasonable disagreement on many issues. Nevertheless, these disagreements exist against a background of received knowledge shared by all competent members of these professions. Indeed, we have licensing examinations for such professions precisely to test whether people seeking to enter these professions have mastered this body of knowledge.

There is nothing comparable in business. Businesspeople deal in matters that, in the end, inevitably involve predicting human behavior on a mass scale: which products will people want to buy, how much will they pay for them, how will they react to market and economic changes, and so on.⁶⁰ Making such predictions, it turns out, is extremely difficult—indeed, largely beyond human ability. There is no natural science underlying business decisions. If business is based on any kind of organized knowledge at all, it is based on social science, not natural science. Because the natural sciences allow us to make very accurate predictions about the future in a broad range of cases, and because the social sciences do not give us any comparable predictive power, business decisions are by their nature much more uncertain than decisions in professions that apply natural sciences.

In other words, estimating the effects of business decisions generally involves predicting the future in ways that human beings are largely incapable of doing. For example, the outcome of a business decision may depend on future conditions in particular markets, the responses of competitors, the pace of technological innovation, the future behavior of capital markets, and the future behavior of the economy as whole. Human powers to predict all of these things are severely limited. Predicting the behavior of financial markets, of course, is notoriously difficult and, assuming the truth of the semi-strong version of the efficient capital markets hypothesis, largely impossible. Responding to competitors—who have every incentive to keep secret their own plans and to foil the

60. Cf. EASTERBROOK & FISCHEL, *supra* note 4, at 98 (“How can the court know whether a poor outcome of a business decision is attributable to poor management (inputs) or to the many other things that affect firms? A decision is good to the extent it has a high *expected* value, although it may also have a high variance. To observe that things turned out poorly *ex post*, perhaps because of competitors’ reactions, or regulations, or changes in interest rates, or consumers’ fickleness, is not to know that the decision was wrong *ex ante*.”).

company's plans—is in many ways akin to waging war, which, because of its inherent unpredictability, Churchill once described as mainly a catalogue of blunders.⁶¹ Doctors and engineers need not grapple with intelligent agents out to thwart their efforts. Or again, with respect to technological innovation, to *predict* (at least in substantive detail) a technological innovation is usually equivalent to effecting the innovation oneself. To predict the invention of the wheel is just to invent the wheel, and so predicting technological innovation may well be impossible not only in practice but even in principle.⁶²

For example, in *In re IBP Shareholders Litigation*,⁶³ Tyson Foods entered into a binding merger agreement to acquire IBP, but Tyson began to suffer buyer's regret and attempted to terminate the merger agreement before closing, largely because a severe winter had negatively affected cattle herds and made IBP's meat business at least temporarily less profitable than Tyson had expected. Here, what turned a good business deal into a bad business deal was human inability to predict the weather a few months in advance. And, from IBP's point of view, a good deal turned into litigation because the individuals controlling Tyson tried to escape from the bargain they made—something that IBP's managers, who knew and trusted Tyson's managers, could not have foreseen.

Now, these two points—that courts do not review business decisions because businesspeople know better than courts and that courts do not review business decisions because such decisions often involve imponderable variables that outstrip human abilities to predict—might not seem to sit well together. The first presupposes that there is some knowledge that businesspeople have that courts lack, whereas the second generally denies the existence of such supposed knowledge in a wide range of cases. There is, however, no real contradiction. That there is *some* information conducive to making good business decisions in some cases can hardly be denied, and it is clear that businesspeople, are more likely to have such information than are courts. Nevertheless, even with this information, business decisions generally involve imponderable variables and are extremely uncertain.

And this is quite enough to show why the substantive review of business decisions of boards by courts would likely not result in better decisions in the long run. To idealize for a moment, if making a business decision were as random as a roll of a fair die, it would clearly make no sense at all to have the court, rather than the board, roll the die. Similarly, it would make no sense to have the court re-roll the die after the board's

61. WINSTON S. CHURCHILL, HISTORY OF THE SECOND WORLD WAR: THE GRAND ALLIANCE 353 (1951).

62. ALASDAIR MACINTYRE, AFTER VIRTUE 93-100 (1982).

63. 789 A.2d 14 (Del. Ch. 2001).

initial throw, for the re-roll would be no more successful than the original throw. Of course, business decisions are not perfectly random, but once clearly crazy alternatives are eliminated (this is the function of the rational business purpose component of the business judgment rule), business decisions are *extremely* uncertain. Hence, the probability that a court's review of a business decision will produce a better decision in any given case than the initial judgment of informed directors free of conflicts of interest approaches one-half. In the long run, therefore, the court is as likely to make worse decisions than the board as it is to make better ones, and so there is no long-term benefit in litigating business judgments to obtain judicial review. But since there are very significant costs of such litigation, including not only the obvious financial costs to the corporation and other litigants but also the opportunity costs associated with the distraction of senior managers that litigation causes, in the long term substantive review by courts of the board's business decisions will destroy value, not create value, for shareholders.

Put another way, since business decisions are especially uncertain, having courts review business decisions on the merits would merely replicate on a new level, with slightly less competent decision-makers, the highly uncertain decisions made by directors. When a new level of decision-makers adds so little value, the costs of such review exceed the benefits. We see something similar when appellate courts refuse to review *de novo* the factual findings of lower courts. Factfinding, like making business decisions, is a very uncertain business, and since appellate courts are not likely to find facts more accurately than lower courts do, the costs of a *de novo* review greatly outweigh the benefits.

Hence, the best protection of shareholder interests actually available turns out to be the honest business judgment of informed directors free from conflicts of interest. Provided that the process of directorial decision making is good, courts are unlikely to add value by reviewing the substance of a business decision, the matter being so uncertain that courts are as likely to get it wrong as boards or even more so. Courts can, however, usefully review the procedural aspects of business decisions, and thus do so under the rubric of the business judgment rule.

These conclusions are confirmed when we consider the substantive standards that Delaware courts apply after the inquiry into the process of directorial decision making is concluded, i.e., rational business purpose review and entire fairness review. What is striking about both standards is that neither is the standard that the directors themselves are required to apply under the business judgment rule, i.e., whether a particular action advances the best interests of the corporation by maximizing shareholder value.

As to the rational business purpose standard, it concerns not whether

the challenged transaction maximizes shareholder value but merely whether thinking the decision maximizes such value is rational in some minimal sense. Given that the court applies this standard only after concluding that the board's decision in favor of the challenged transaction represented the honest judgment of an informed decision-maker free from conflicts of interest, it is hardly surprising that such decisions virtually always survive scrutiny under this standard. Informed, honest fiduciaries, especially those talented enough to be tapped to sit on the boards of public companies, rarely do things that are stark raving mad—which is roughly what it takes to violate the rational business purpose standard. Indeed, the rational business purpose standard is so easily and thus so frequently satisfied that some commentators have concluded that it adds nothing of value to Delaware jurisprudence and so should be abolished.⁶⁴ If the argument here is correct, however, these commentators are wrong. The rational business purpose standard, as explained above, reduces the universe of possible business decisions down to one within which the court is no longer able to add value by reviewing the substance of business decisions.

As to entire fairness review, it too fails to consider whether a particular action maximizes shareholder value. Given that the courts engage in such a review when the process leading to the board's business decision has been fatally compromised, the standard should involve a rigorous scrutiny of the merits of the transaction. Rigorous as entire fairness review is, however, it seems that it would be easier for the defendant directors to prove that the transaction was fair than that it maximized shareholder value. Thus, even when a consideration of the merits of the transaction would seem entirely warranted, Delaware courts avoid reviewing business judgments in the manner directors themselves are required to do so. Why is this?

The answer is that, in shifting the standard from value-maximization to fairness, the law appeals to concepts that lawyers and judges are better

64. The true function of the rational business purpose requirement, however, is probably to assist deserving plaintiffs facing nearly insurmountable proof problems in certain duty of good faith cases. That is, an informed board free from conflicts of interest could falsely claim that it believes that some particular action is in the best interests of the corporation, and given the difficulty of disproving the directors' assertions about their own states of mind, it would be extremely hard for plaintiffs to prevail in such circumstances even though they would deserve to do so. If the action is patently injurious to the corporation, a court can use the rational business purpose standard to enjoin the action or else to hold the board liable. Hence, we find various dicta in Delaware cases that a business decision that fails the rational business purpose test would be "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified in part on reh'g*, 636 A.2d 956 (Del. 1994); *Orman v. Cullman*, 794 A.2d 5, 20 n.32 (Del. Ch. 2002); *In re J.P. Stevens & Co., Inc.*, 542 A.2d 770, 780-81 (Del. Ch. 1988).

able to apply. Fairness of process is a paradigmatically lawyerly concern, and so the fair-process component of the standard is eminently within the competence of judges. The fair-price component, to be sure, inevitably involves consideration of business issues, but even inquiring into the *fairness* of price is not totally foreign to judicial decision-making. Legal standards embodying the concept of *fair market value* figure in everything from fraudulent transfers, to the tort of conversion, to just compensation under the takings clause. Unlike a standard involving maximizing shareholder value, which invites consideration of future probabilities and risk tolerances, appeals to fairness often involve appeals to current market prices, recent comparable transactions, values that other parties have paid or seemed willing to pay, and so on—to factors, in other words, that lawyers and judges find easier to work with. Entire fairness is, in the end, itself a process-based standard: a result is fair if it is the result that would come about as a result of market processes, i.e., arms-length dealing between independent parties in the market.⁶⁵

I have reviewed the Delaware business judgment rule here in order to begin the process of adapting it to cases of director omissions, and I argued that the main elements of that rule are three: (a) the belief that the honest, informed judgment of businesspeople free from conflicts of interest is the best protection of shareholder interests in the long run, with the result that (b) courts should concentrate on the process of corporate decision-making rather than the substance of business decisions, and (c) the law should produce strong incentives for honest directors to use good process by guaranteeing that substantive review of their decisions by courts will be limited to cases in which there have been breaches of good process.

The obvious problem in applying these elements to director omissions, as I noted above, is that when directors simply fail to act, there is no process to scrutinize. For this reason among others, courts have tended to invent substantive standards to decide cases of wrongful director omissions. In order to establish what kinds of results adapting the process model of the Delaware rule to omissions should entail, I now turn to some of the more important and best-reasoned cases of wrongful director omissions, culminating with the Delaware Supreme Court's attempt to articulate a definitive standard in *Stone v. Ritter*.

65. Cf. EASTERBROOK & FISCHER, *supra* note 4, at 104 (saying that “fair” in the context of the business judgment rule means “the firm receives a deal at least as good as it could have obtained in an arm’s-length transaction with a stranger”).

II. EXISTING CASE LAW ON WRONGFUL OMISSIONS: *PER SE* RULES, *AD HOC* DETERMINATIONS, AND THE MOVE TO SUBJECTIVE WRONGDOING

The existing case law on wrongful director omissions falls into three main bodies: (a) in cases such as *Francis v. United Jersey Bank*,⁶⁶ courts have announced what amount to *per se* rules, declaring that there are certain things about the corporation and its activities that directors should always know; (b) in other cases, such as *Graham v. Allis-Chalmers*,⁶⁷ courts have determined on an *ad hoc* basis whether in the specific circumstances of the case the directors should have known of certain facts that would presumably have led them to take action; and (c) in *Caremark* as elaborated in *Stone*, courts have abandoned altogether the problem of saying what directors *should* know and have declared that directors will be liable only when they actually *know* that they have omitted to do things that they ought to have done.

A. *The Per Se Approach*: *Francis v. United Jersey Bank*

Francis v. United Jersey Bank concerns the unhappy story of Pritchard & Baird Intermediaries Corporation, a close corporation in the reinsurance brokerage business. After the death of the corporation's founder, control of the corporation passed to his wife, who became a director of the corporation and its largest shareholder, and to his sons, who were shareholders, directors, and officers of the corporation. As part of its usual business, the corporation held in trust large amounts of money for its clients. The sons, acting in their capacities as officers, purported to lend themselves this money, and they recorded the amounts as "shareholders' loans" on the company's financial statements. They paid no interest on the purported loans and certainly never repaid the amounts taken from the company. The trial court concluded that the loans were a sham and that the sons had in fact engaged in "a massive misappropriation of money belonging to the clients of the corporation."⁶⁸ This draining of money from the company eventually led to its bankruptcy.

Their mother, meanwhile, had done nothing whatsoever in her capacity as a director—not only nothing to stop the misappropriation, but literally nothing at all. Mrs. Pritchard "was not active in the business . . . and knew virtually nothing of its corporate affairs"; she had "briefly visited the corporate offices . . . on only one occasion, and she never read or

66. 432 A.2d 814 (N.J. 1981).

67. 188 A.2d 125 (Del. 1963).

68. *Francis*, 432 A.2d at 819.

obtained the annual financial statements” of the company.⁶⁹ In fact, “she never made the slightest effort to discharge any of her responsibilities as a director.”⁷⁰ The plaintiff’s claim on behalf of the corporation, therefore, was a classic claim of wrongful omissions by a director. “The primary issue,” the court said, “is whether a corporate director is personally liable in negligence for the failure to prevent” wrongdoing by corporate officers.⁷¹ In language that anticipates Chancellor Allen’s view that such a theory is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,”⁷² the court stated that when a plaintiff “asserts that a director, because of nonfeasance, is liable for losses caused by acts of insiders,” the “problem is particularly nettlesome.”⁷³

The court said that the existence of liability depended on findings that the director had a duty to prevent the loss, that she breached that duty, and that the breach was the proximate cause of the loss, thus drawing a close analogy with an ordinary negligence claim.⁷⁴ The court dealt with the first and, for our purposes, most important point by in effect announcing a set of rules concerning what a director ought to know about the corporation he or she serves. Thus, (a) “as a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation” and “become familiar with the fundamentals of the business in which the corporation is engaged,”⁷⁵ (b) “a director is well advised to attend board meetings regularly,”⁷⁶ (c) a director “should maintain familiarity with the financial status of the corporation by a regular review of financial statements,”⁷⁷ and (d) “[u]pon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign.”⁷⁸ If Mrs. Pritchard had understood the basics of the reinsurance business, attended meetings, and been familiar with the financial status of the corporation, she could not have helped but to discover the looting of the corporation by her sons. Accordingly, the New Jersey Supreme Court had no difficulty concluding that she had breached her duties as a director.

Thus, although the court never characterized it this way, its approach to the problem of director omissions was to announce some basic rules about what directors should always know about their corporation—things

69. *Id.* at 819.

70. *Id.* at 820 (citing the lower court’s decision in *Francis v. United Jersey Bank*, 392 A.2d 1233, 1241 (N.J. Super. Ct. Law Div. 1978)).

71. *Id.*, at 816.

72. *Caremark*, 698 A.2d at 967.

73. *Francis*, 432 A.2d at 820.

74. *Id.* at 820.

75. *Id.* at 821-22.

76. *Id.* at 822.

77. *Id.*

78. *Id.* at 823.

that they should know *per se*, that is, without regard to the circumstances. It is, moreover, very hard to argue with any of the rules the court announced. Who would deny, for example, that directors should always know the basics of the business of the company and have read its financial statements? The court's rules are plausible, however, only because they set such a very low standard: these are indeed things that *any* director should know about the corporation he or she serves. For a particular director of a particular corporation, there will always be more about the corporation that the director should know than will be captured by such *per se* rules. What more directors should know about the state of the corporation, however, depends very much on the circumstances. *Per se* rules were sufficient to decide *Francis v. United Jersey* only because the defendant director's failure to monitor the activities of the corporation was so complete. She failed to do not only what the peculiar circumstances of the case required, but also what any circumstances of any case would have required.

Such *per se* rules are useful as far as they go. They provide a necessary (but not sufficient) condition for any purported standard for the wrongfulness of director omissions in the sense that any such standard should entail these rules. What *per se* rules do not do, however, is provide a general standard explaining what sorts of things directors should know in what sorts of circumstances. The harder cases concern not directors who completely failed to be informed but rather generally informed boards of directors that have observed all the *per se* rules we could plausibly articulate but that were nevertheless ignorant of particular matters related to the corporation—matters that, according to the shareholder plaintiff, they should in the totality of the circumstances have known about. To deal with cases like that, courts had to adopt quite a different approach.

B. The Ad Hoc Approach: Graham v. Allis-Chalmers

In *Graham v. Allis-Chalmers*, subordinate employees of a large manufacturing company engaged in a price-fixing and bid-rigging conspiracy with some of the company's competitors. As a result, the company itself was indicted under Section 1 of the Sherman Act, pled guilty, and suffered various corporate losses as a result. A shareholder brought a derivative action on behalf of the corporation against certain of its directors seeking to recover for such losses. At least by the time the case reached the Delaware Supreme Court, there was no allegation that the directors participated in, or were even aware of, the illegal actions by the company's employees. Rather, the plaintiff's argument was that the defendant directors should be liable for their mere omissions, that is, "by reason of their failure to take action designed to learn of and prevent anti-

trust activity on the part of any employees of Allis-Chalmers.”⁷⁹

The court starts its analysis with a long recitation of facts describing the very large size of Allis-Chalmers—e.g., 31,000 employees, 24 plants, 145 sales offices, etc.—which creates the doubtlessly correct impression that it would be very difficult for directors to know what all the employees of Allis-Chalmers were doing on a day-to-day basis.⁸⁰ In case this point is lost on the reader, the court then describes the decentralized management structure of the company, noting that “because of the complexity of the company’s operations the Board does not participate in decisions fixing the prices of specific products” and that “it is not practicable for the Board to consider in detail specific problems of the various divisions” of the company.⁸¹ This shift from what the board *in fact* does not do to what it is *impracticable* for the board to do is significant because it is a shift from the descriptive to the normative. Without expressly saying why, the court has already started to reach normative conclusions about what the board should have known about the actions of subordinate employees.

The plaintiffs in the case had argued that, because the company had entered into two consent decrees with the Federal Trade Commission in 1937 related to alleged antitrust violations, the board was somehow especially on notice, twenty years later in 1959, that the company’s employees were likely to violate the antitrust laws. The court treated this argument by reciting more facts—that the current directors were either not associated with Allis-Chalmers in 1937 or else were employed in very junior capacities, that current senior management had in the 1940s satisfied itself that the company was complying with the decrees and had not in fact violated the antitrust laws in the first place, etc. On this basis, the court states without further elaboration, “Under the circumstances, we think knowledge by [some of the director defendants] . . . that in 1937 the company had consented to the entry of decrees enjoining it from doing something they had satisfied themselves it had never done, did not put the Board on notice of the possibility of future illegal price fixing.”⁸² This is no doubt true, but it leaves unexplained the normative criteria—the general considerations that make it reasonable or not reasonable to expect the board to know something—to which the court is here appealing.

Attempting to formulate a general principle of law, and relying on *Briggs v. Spaulding*⁸³ and *Bowerman v. Hamner*,⁸⁴ the court is able to say

79. *Graham v. Allis-Chalmers*, 188 A.2d 125, 127 (Del. 1963).

80. *Id.* at 125, 128.

81. *Id.*

82. *Id.* at 129.

83. 141 U.S. 132 (1891) (holding that the degree of care required of directors of corporations should be determined in view of all the circumstances of the case at hand).

84. 250 U.S. 504 (1919) (requiring the director of a national bank to exercise at least ordinary care and prudence in the supervision and administration of the bank’s affairs).

little more than that directors have a duty “of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts of the particular case.”⁸⁵ And, “absent [a] cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”⁸⁶ Taken literally, this would seem to imply that directors do not have a general duty to take steps to be informed about the activities of subordinate employees. As Chancellor Allen would later note in *Caremark*, whatever may have been in the case in 1963, such a rule seems unsupportable in current circumstances.⁸⁷

It is unlikely, however, that even the *Allis-Chalmers* court would have gone that far, for such would have been a fairly definite rule, and the court was committed to not having definite rules in this area. “In the last analysis,” the court held, “the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances.”⁸⁸ If a corporate director “has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.”⁸⁹ But this says nothing more than that directors should know what directors should know, which is as true as it is uninformative. The words *should know* are not helpfully glossed by appeals to phrases like “cavalier neglect” or “willful inattention.”

This is not to say, however, that *Allis-Chalmers* did nothing to advance the law. For one thing, it announced that the fact pattern disclosed in the case would fall far outside the range of cases in which directors should know about wrongdoing by corporate employees. The common law method of reasoning by analogy can settle cases on the basis of such examples, and thus one good example plus the general methods of common law reasoning can go far towards marking out where the line will ultimately fall. Indeed, a standard of what directors *should know* gets part of its content from a set of clear examples of what directors should know and another set of clear examples of what directors should not have to know. Still, as Holmes famously said, “a body of law is more rational and more civilized when every rule [in it] . . . [can] be stated in words.”⁹⁰ On

85. *Graham*, 188 A.2d at 130.

86. *Id.*

87. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 969-970 (Del. Ch. 1996) (rejecting an overly broad interpretation of *Graham*).

88. *Graham*, 188 A.2d at 130.

89. *Id.*

90. Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

this score, *Allis-Chalmers* helps us not at all.

It was not surprising, therefore, that when Chancellor Allen took up this problem again in 1996, he sought a better standard than he found in *Allis-Chalmers*.

C. *The Subjective Wrongdoing Approach in Caremark and Stone*

In *Caremark*, shareholders of the corporation brought a derivative suit against the directors for failing to prevent Caremark employees from violating the federal Anti-Referral Payments Law, a statute that prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients to the person paying the remuneration. Prior to the suit, some subordinate Caremark officers and the company itself had been indicted for violating this statute in connection with various consultation agreements and research grant agreements that Caremark had with physicians. Eventually, Caremark reached a settlement with the government pursuant to which it pled guilty to a single count of mail fraud and paid substantial criminal and civil fines, but was permitted to continue to participate in Medicare and Medicaid programs. Subsequently, it agreed to make further payments to various private and public parties, and the total loss to the company aggregated approximately a quarter of a billion dollars. The shareholder derivative action was premised on the theory that the directors were liable to the corporation for failing to supervise or monitor the corporation's operations. As Chancellor Allen put it, "[t]he claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."⁹¹

Agreeing that "liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss,"⁹² Chancellor Allen considered the holding in *Allis-Chalmers* and, not surprisingly, found it not especially helpful in formulating a general principle as to when directors should be liable for their "unconsidered inaction."⁹³ He read that case, rather, as standing for the limited proposition that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."⁹⁴ In attempting to formulate a principle concerning

91. *Caremark*, 698 A.2d at 967.

92. *Id.* at 967 (emphasis in original).

93. *Id.* at 968.

94. *Id.* at 969.

what directors should know about the corporation, he first indicated a statutory basis for such a principle, arguing that “relevant and timely *information* is an essential predicate for satisfaction of the board’s supervisory and monitoring role under Section 141 of the Delaware General Corporation Law.”⁹⁵ In other words, a duty to manage implies a duty to be informed of the relevant information needed to manage. Thus, Chancellor Allen concluded that there is a duty of some kind to have an information and reporting system that delivers to the board relevant information about the corporation.

Unfortunately, Chancellor Allen formulated this duty three different times in the opinion, and did so slightly differently each time. In one formulation, the board had a duty to assure itself that

information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.⁹⁶

The reference to reasonability here seems to imply that courts would evaluate the information and reporting systems for reasonability in the circumstances. In the second formulation, however, the reasonability qualification drops out and the duty becomes one to “exercise a good faith judgment that the corporation’s information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.”⁹⁷ Here, the obligation seems to be not to have a reasonable information and reporting system but only one that the board honestly (i.e., “in good faith”) thinks is adequate, and this makes it sound as if courts will *not* review the reasonability of the system, just the board’s subjective judgment of the adequacy of that system. Finally, Chancellor Allen hedges even further, writing that

A director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.⁹⁸

This standard seems to be the same as the second, but now failure to

95. *Id.* at 970 (emphasis in original).

96. *Id.*

97. *Id.*

98. *Id.*

comply with it supports liability—“in theory, at least”—only “under certain circumstances,” which remain unspecified.

The first formulation of the duty—the duty to have a reasonable information and reporting system—may appear to be the right one because it seems to parallel the duty of care as applied to deliberate decisions by the board. For, in determining whether a deliberate decision by the board was made in accordance with the duty of care, the question is whether the board was informed of all the material facts reasonably available at the time of the decision.⁹⁹ This inquiry is objective: it is not a question of whether the board honestly believed that it knew everything that it should, but whether the board really did know everything that it should,¹⁰⁰ with the court making an independent judgment as to whether a particular fact was material and reasonably available. Hence, if omissions by directors should—so far as possible—be reviewed by courts in the same way as deliberate decisions by directors, it would seem that review of omissions should include an objective inquiry into whether directors knew what they should have known—i.e., whether they had in place a reasonable information and reporting system—and so it would seem that this first formulation from *Caremark* should be the right one.

But what is a *reasonable* information and reporting system? To see how difficult and fact-specific this question is, contrast it with the inquiry in a duty of care situation for deliberate decisions, i.e., the inquiry whether the board had gathered all the material information reasonably available. In the duty of care situation, there is one definite transaction on which to focus—and a transaction so important to the corporation that the board itself is making the decision. That drastically limits the universe of potentially material information. Generally speaking, we are talking about discrete, major, reasonably well-understood kinds of corporate transactions—mergers and acquisitions, hiring and compensating chief executive officers, engaging outside auditors, etc.—about which there is significant agreement as to which information is material. With the case of a corporate information and reporting system, however, we do not know *ex ante* what the allegedly wrongful omission by the board will be. At the

99. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (holding that a corporate board is not entitled to the protection of the business judgment rule if decision is uninformed).

100. Of course, if the board believed that it was making a deliberate decision without knowing all the material facts reasonably available, then it would be acting in conscious disregard of its duty and, as a result, breach the duty of good faith. Notice, however, that it would not necessarily be breaching the duty of care. For instance, if the board made the decision thinking that certain information that it failed to gather was material and reasonably available but in fact the material was not available, the board may well have all the material information reasonably available and as such was acting in accordance with its duty of care. It still would be breaching its duty of good faith.

time the system is designed and implemented, there is a vast, indefinite universe of potentially relevant information only some tiny, undetermined part of which will be relevant to the omission later charged. Put another way, to determine whether a corporate information and reporting system is reasonable, we would have to determine whether, for each item of information known somewhere in the corporation, it was reasonable to report that item to the board. For a corporation of any size, that would be an absolutely daunting task. In any event, it is an immensely more difficult question than that at issue in a duty of care inquiry concerning a deliberate decision by the board to undertake some particular transaction.

More important, whether an information and reporting system is reasonable is itself a substantive business decision. For, assuming that a *reasonable* system is one that maximizes shareholder value in the long run, a system will be reasonable if the benefits of the system, in the form of improved decision-making by the board, exceed the costs of designing and implementing it. Measuring these costs and benefits and balancing the one against the other is exactly the kind of highly uncertain judgment at issue in business decisions. If courts, therefore, started passing on the issue of the *reasonability* of corporate information and reporting systems, they would be making paradigmatic business decisions and so displacing the board of directors. And if the business judgment rule means anything, it ought to prevent exactly such judicial intrusions. Thus, although Chancellor Allen's first formulation in *Caremark* of the duty to have a corporate information and reporting system would subject director omissions to a standard of review at least superficially analogous to that used to evaluate deliberate decisions, it is clearly not one consistent with the policies underlying the business judgment rule.

After some controversy over exactly what the *Caremark* standard was,¹⁰¹ the Delaware Supreme Court settled the issue in *Stone v. Ritter*. There, the court endorsed and elaborated on the second formulation from *Caremark*, holding that "the necessary conditions predicate for director oversight liability" are that either "the directors utterly failed to implement any reporting or information systems or controls[.]" or "having implemented such a system or controls, consciously failed to monitor or oversee its operations"¹⁰² The court is very clear, however, that in

101. See, e.g., Guttman v. Huang, 823 A.2d 492 (Del. Ch. 2003), in which Vice Chancellor Strine argues for an understanding of *Caremark* along the lines the Delaware Supreme Court would later adopt in *Stone v. Ritter*.

102. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). The court here says that these are *necessary* conditions for liability, thus raising the question of whether they are also *sufficient* conditions. It seems that they are, for whenever such conditions are fulfilled, the directors will have acted in bad faith and so, according to the *Stone* court, have breached the duty of loyalty. Thus, "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty

“either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”¹⁰³

Stone thus eschews any inquiry into whether a corporate reporting and information system is reasonable. All that matters is whether the directors honestly believed that they had fulfilled their duty to create and utilize such a system. It is easy to see this rule as an example of the court going easy on management, but that would probably be a mistake. The rule *is* easy on management, but what motivated the court was, more likely, a desire to go easy on itself—or, more accurately, a desire to formulate a judicable rule. As I argued above, determining whether a reporting and information system was reasonable under the circumstances would be very difficult for judges and would, moreover, intrude on the business judgment of the board. In all probability, it would also yield results not more useful than the difficult, fact-intensive inquiries that courts have to undertake under the *ad hoc* approach of *Allis-Chalmers*. The *Stone* standard thus eliminates—for the court, at least—the fact-intensive question of what directors should know about their particular corporations. Under *Stone*, there is no such inquiry.

Or, more accurately, there is no such inquiry *by the court*. The court’s inquiry concerns whether directors knew that they *did not know* what they *should have known*—and this implies that the directors themselves must decide what they *should have known*, i.e., whether the information and reporting system they have put in place was reasonable in the sense of value-maximizing for shareholders. The decision to adopt such a system is, and would no doubt be treated by courts, as a paradigm business decision reviewable under the business judgment rule. The remaining problem is whether the board’s subsequent use of that system—whether the board knows what it *should know* on an ongoing basis—cannot be reviewed by courts in any way more stringent than under the subjective wrongdoing standard of *Caremark* and *Stone*. If this solution is to be improved upon, we need a way for courts to conduct an objective inquiry into whether directors know what they should about the operations of the corporation, and moreover this inquiry should not at any point involve substituting the court’s business judgment for the board’s. I now turn to working out such a solution.

III. ADAPTING THE PROCESS MODEL OF THE BUSINESS JUDGMENT RULE

In reviewing the Delaware business judgment rule above, I argued that (a) the rule is founded on the theory that the best protection of shareholder

of loyalty by failing to discharge that fiduciary obligation in good faith.” *Id.*

103. *Id.* (citing *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003)).

interests in the long run is the honest, informed judgment of businesspeople free from conflicts of interest, and thus (b) courts, rightly scrutinize the process of decision-making rather than the substance of business decisions, and (c) the law should produce strong incentives for honest directors to use good process in reaching decisions by guaranteeing that courts will not second-guess their business decisions on the merits. In reviewing some of the more important decisions regarding director omissions, I argued that the major problem facing courts attempting to design a legal standard governing such omissions is the problem of determining which facts directors *should know* about their corporations. None of the major approaches that courts have developed thus far—not the *per se* approach, the *ad hoc* approach, or the subjective wrongdoing approach—have made significant progress on this problem because the question of what directors should know seems dependent on very complex facts that will vary dramatically from case to case. Answering the question, moreover, involves making business decisions of the very kind that, under the business judgment rule, courts ought *not* be making.

A. *Determining What Directors Should Know*

This last point is where we must begin. If we could settle the issue of what the board should know about the corporation, we would be well on our way to a process-based standard governing director omissions. For, with the knowledge issue settled, when a board knew everything that it should have known (and was free from conflicts of interest and omitted to act in the honest belief that it had no duty to act, i.e., had no belief that the action was required to maximize shareholder value), we could say that an omission by the board would not subject it to liability if the omission passes rational business purpose review. That is, an omission by such a board would stand unless, knowing what the board knew, omitting to act could not be attributed to any rational business purpose—or, equivalently, that knowing what the board knew, any rational business person would have acted.

As we saw above, however, the problem of determining what a board *should* know about the corporation seems intractable because of the fact-specific nature of the question and the business judgment issues involved. A solution begins to appear, however, if we return to the idea of process and the insight that it would be very useful if the determination of what a board should know about the corporation could be made *ex ante*, that is, before a case arises in which the board is alleged to have made a wrongful omission. For, if the scope of the board's required knowledge is determined only *ex post*, then any rule creating strong incentives for directors to have this knowledge will tend to create *overly strong*

incentives. That is, the rule may give directors incentives to gather too much information regarding the operations of the corporation in order to avoid a determination *ex post* that they gathered too little. Thus, in order to create the right incentives for the board to gather the efficient quantity of information (i.e., how much it *should* gather), it will help if the scope of the board's required knowledge be clearly determined *ex ante*.

Courts, because they decide only litigated cases, cannot determine in advance what the scope of the directors' knowledge for any given corporation ought to be.¹⁰⁴ Legislatures can act before controversies arise, but the fact-intensive nature of the determination of what directors should know about their particular corporation will obviously prevent legislatures from articulating a useful standard. The legislature cannot articulate a particularized rule for each corporation. Furthermore, neither courts nor legislators should be intruding on the issues of business judgment bound up in determining what a board should know about the affairs of the corporation.

Hence, we need some authority, intimately familiar with the corporation, which is able to determine in advance what knowledge is required of the directors of that corporation and fitted for making business decisions. There is, of course, only one plausible decision maker here: the board of directors itself. For no one knows the affairs of the corporation better and so no one is in a better position to judge what knowledge directors of the corporation ought to have, and it is, of course, the board that ought to be making business decisions. The board is well-placed—or at least best placed—to articulate a standard of what directors should know, and it could do so simply by resolution.

Such a resolution could be as detailed as may be desired. Ideally, it would likely include some of the *per se* rules of the kind discussed above—e.g., that directors should know the contents of the corporation's organizational documents, its financial statements, its filings with the Securities and Exchange Commission, its material contracts, and so on. The resolution would be integrated with management's assessment of internal controls under Section 404 of Sarbanes-Oxley Act. Other provisions of the resolution would be tailored to the nature of the business. Directors of a television broadcasting company might be required to know the principal terms of licenses granted by the Federal Communications Commission, for example, while directors of a bank might be required to be familiar with key provisions in the federal banking laws. The resolution would also specify the important aspects of the corporation's information and reporting system, what information should be generated by that system,

104. Note how the court in *Francis v. United Jersey Bank* essentially tried to do so, however, perhaps because it sensed the problem considered herein.

and what information thus generated board members should be familiar with. A board resolution spelling out these requirements would become one of the key corporate governance documents of the company. The board could review it periodically and amend it as circumstances may warrant. Its adoption would be a business decision of the board—that is, an active and deliberate business decision—and this decision to set a standard of what directors of the corporation *should know* would itself be reviewed under the business judgment rule. In adopting an information and reporting system, the board is already implicitly making a judgment as to what it should know about the corporation. The resolution envisioned here would require that the board make that judgment explicitly.

With the scope of the board's required knowledge defined, we can state a workable rule for judicial review of alleged wrongful omissions by directors. When a plaintiff shareholder sues the board claiming that an omission by the directors was wrongful, the burden shall first be on the plaintiff to show that a majority of the directors breached one or more of their fiduciary duties of care, loyalty or good faith. The duties of loyalty and good faith would mean in this context very much what they mean in the usual business judgment cases: a director breaches the duty of loyalty if he or she actually knew of the possibility of the action that plaintiffs claim was wrongfully omitted but was interested in the omission or lacked independence, and the director breaches the duty of good faith if he or she actually knew of the possibility of the action and honestly believed that the possible action was required under the wealth-maximization standard but nevertheless chose not to act. A director breaches the duty of care in an omission case if the possibility of the action that plaintiffs claim was wrongfully omitted was within the scope of knowledge required of directors under the board's standard-setting resolution but the director did not possess such knowledge. In other words, the board *ex ante* will create a detailed rule about what directors should know tailored to the facts and circumstances of the particular corporation and resolving the business judgment issues implicit in creating such a standard; the court *ex post* will determine in an objective inquiry whether the individual directors have lived up to the rule the board has set for itself.

If the directors have not breached their duties of care, loyalty, or good faith, then the court will review the omission under the rational business purpose standard. That is, the court will determine whether a director, having all the knowledge within the required scope plus whatever actual knowledge the directors have (the burden being on the plaintiff to prove such actual knowledge), could rationally have believed that omitting the action had a rational business purpose, i.e., was value-maximizing for shareholders. As with rational business inquiries in the case of deliberate decisions by the board, the board will almost always prevail. In omissions

cases, however, there will be one important exception. Since the range of actions that can have rational business purposes does not extend to illegal actions, and since value-maximization means value-maximization within the law, omitting to stop illegal conduct by the corporation or its employees will never have a rational business purpose. Hence, the directors who knew of such conduct, or should have known of it in the sense that knowledge of such conduct was within the scope of their required knowledge, will have an absolute duty to stop such conduct. On the other hand, if a majority of the directors have breached their fiduciary duties of care, loyalty, or good faith in relation to the omission, then, as is usual under the business judgment rule, the burden would shift to the directors to prove that the omission was entirely fair to the corporation.

To create incentives for boards to adopt the kind of standard-setting resolution suggested here, if a board has neglected to act by resolution to set the standard of its own fiduciary duty to be informed, then the court should adopt the *ad hoc* approach of *Allis-Chalmers* and decide for itself whether the board should have known the facts in question. As I argued above, this approach is in many ways suboptimal, but it is very useful here, because the threat of such an *ad hoc*, after-the-fact inquiry should provide the board with a strong incentive to adopt an appropriate resolution regarding the scope of its duty to be informed. The point of the business judgment rule generally is to encourage boards to use good process and to reward boards that do so by sparing them second-guessing of their business decisions by courts. The threat of an amorphous inquiry into what directors should have known after a loss has occurred should be a sufficient incentive for directors to determine ahead of time what they should know about the affairs of their corporation.

B. *Comparison With Caremark and Stone*

It is important to see how the rule proposed here differs from that in *Caremark* and *Stone*. Under that rule, there is no requirement whatsoever that the board act reasonably in designing and implementing a corporate information and reporting system; the requirement is merely that the board act honestly, i.e., that it neither fail to implement a system nor fail to benefit from a system already implemented—in each case knowing that it should be doing such things. Under the rule proposed here, the board—which is in a good position to determine what a reasonable system for its particular corporation would look like—is required to do so *ex ante*, thus creating a detailed standard of reasonability (tailored to the particular corporation and resolving the business judgment issues implicit therein) that a court can apply *ex post*, determining whether the board lived up to a standard it has itself declared reasonable. Directors, to be sure, cannot

justly complain of the proposed rule, for it merely requires that they know *ex post* what they themselves had determined *ex ante* they should have known. In fact, since *Stone* already makes implicit use of the idea that directors must have determined what they should know about the corporation (a director can consciously disregard his or her duty only if he or she has made some judgment as to what that duty is), the rule proposed here is in one respect *more* friendly to directors because it requires that the standard to which directors will be held be set out explicitly *ex ante* and not be left merely implicit in the directors' decision to adopt a certain kind of information and reporting system.

Now, the obvious objection to letting the board itself determine what it should know about the corporation is that, in order to avoid later being found to have known too little, the board will have a strong incentive to set the standard too low. This is a serious objection. The problem might not be as bad as it at first seems, however, for if the board resolution setting the standard for director knowledge became a standard corporate governance document, all the usual extra-legal mechanisms that contribute to good corporate governance would come into play to ensure that the standard the board set was not too low. Boards would face pressure from investors to set the standard appropriately. Directors who were too easy on themselves would face public embarrassment and damage to their professional reputations, criticism from the Institutional Shareholder Services and the Council of Institutional Investors, downward pressure on the corporation's share price, withhold-vote campaigns, and maybe even challenges from insurgent shareholders. Whenever such directors were being criticized on other grounds, shareholder activists and others would add to their complaints a critique of the board's policy on the scope of knowledge required of directors. Nevertheless, just as market forces are a significant but not sufficient check on director conduct in other respects, such forces would likely be helpful but not sufficient in driving a board to adopt an optimal standard for wrongful omissions.

This is not to say, however, that this objection to the proposed rule is fatal. On the contrary, the objection is fatal only if there is an alternative rule that is better. In this regard, it is clear that the rule proposed here is *more stringent* than the rule in *Caremark* and *Stone*. Under that rule, the board is never required to behave reasonably with respect to being informed about the operations of the corporation, regardless of how reasonability might be defined. Under the rule proposed here, the board itself sets, *ex ante*, the detailed content of the rule, but an independent fact-finder—the court—determines *ex post* if the board lived up to the rule. This is not a perfect system, to be sure, but no system in human affairs is perfect, and the rule proposed here is, without a doubt, significantly more protective of shareholder interests than the rule in *Caremark* and *Stone*.

Moreover, it seems clear that any other system would make shareholders worse off. For, if any body other than the board of directors sets the standard of what directors should know, that body will have usurped a business decision of the board, for the *should* in what directors *should know* cannot be given content except through the resolution of business issues, i.e., in deciding whether certain kinds of information and reporting systems are, in the context of the particular corporation, worth their cost. We have, therefore, a dilemma. Either the board sets its own standard for wrongful omissions, or some other decision maker makes a business decision for the board. The argument presented here assumes that shareholders will be better off in the long run by choosing the first prong of this dilemma.

One might try to split the difference here by saying that, although the board should set the standard for wrongful omissions in the first instance, the court should not only determine whether the board lived up to its obligations under the board's standard for being informed but also review the standard itself for reasonability. In other words, the first inquiry in an action alleging a wrongful omission by directors would be an inquiry into whether the standard the directors set for themselves was itself reasonable. From one point of view, this would seem like a sensible requirement. After all, the standard of substantive reasonability is a familiar one in the Delaware law of mergers and acquisitions: it is the *Unocal* standard of enhanced judicial scrutiny.¹⁰⁵ It would, moreover, seem to be especially applicable here. For, Delaware courts apply this standard in situations in which, although directors are neither interested nor lack independence (and so have not breached their duty of loyalty), there is nevertheless special cause for believing that directors are likely to promote their own interests and not those of the corporation and its shareholders—i.e., situations that raise the “specter of self-interest,”¹⁰⁶ such as the implementation of anti-takeover defenses¹⁰⁷ and deal-protection devices.¹⁰⁸ The specter of self-interest would undoubtedly be raised in connection with the board's setting

105. *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

106. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 930 (Del. 2003); *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995); *Unocal*, 493 A.2d at 964. Actually, *Unocal* spoke of the *omnipresent* specter of self-interest, but of course the specter is not present everywhere but only in certain situations—the limited class of cases in which enhanced judicial scrutiny of the board's actions are justified. That this misuse of the word *omnipresent* should have become so persistent in Delaware jurisprudence, sometimes in patently ridiculous ways (“The ‘omnipresent specter’ of such conflict *may be present* whenever a board adopts defensive devices to protect a merger agreement,” *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 930 (Del. 2003) (emphasis added)) is one of the minor mysteries of Delaware corporate law.

107. *E.g.*, *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985) (discussing the poison pill or shareholder rights plan).

108. *E.g.*, *Paramount, Inc. v. Time, Inc. (Time-Warner)*, 571 A.2d 1140 (Del. 1989).

for itself the standard of its own duty to be informed, and so it might seem sensible for courts to review the board's determination for substantive reasonability.

But such an approach will not work. As we saw in cases like *Allis-Chalmers*, determining whether it was reasonable to require a board to have known of certain particular facts concerning corporate operations led to *ad hoc* decisions that seemed to embody no definite standard. Courts could do little more than look at the totality of the facts and circumstances and announce whether they thought the board should have known of the particular matters at issue. A reasonability inquiry concerning the standard the board set for itself *ex ante* would inevitably be *ad hoc*. The court could do little more than survey the nature and complexity of the corporation's operations, summarize the major provisions of the board's resolution concerning the company's information and reporting system, and then announce whether or not it deemed the latter reasonable in relation to the former. We would be replacing one set of *ad hoc* determinations with another.

We can see how similar an *Allis-Chalmers* inquiry and a reasonability inquiry regarding the standard set by the board would be by recognizing that the two would always lead to the same results. For instance, assume that an *Allis-Chalmers* inquiry would conclude that the board should have known of the facts at issue. Since it did not know these facts, then, assuming the board knew everything its information and reporting system was reporting to it, it must be that the board's system was not reasonably designed. Hence, the standard creating the system would fail a reasonability inquiry. On the other hand, assume that a reasonability inquiry would conclude that the board's system was not reasonably designed with respect to the facts at issue in the case, i.e., that the system should have reported these facts to the board but failed to do so. Then it follows that the board should have known of those facts. Assuming that it did not, an *Allis-Chalmers* inquiry would conclude that the board did not know what it should have known. Thus, the *Allis-Chalmers* inquiry and the reasonability inquiry always seem to reach the same results. Hence, it is hard to see how the latter could be an improvement on the former.

Finally, the rule I am proposing here is superior to the rule in *Caremark* and *Stone* in one further respect. Under *Caremark* and *Stone*, the directors are liable only if they subjectively knew that they did not know what they should have known. This can happen only if, at some point or other, the directors determine what they should have known. *Caremark* and *Stone*, however, are silent about when and how this determination is to be made. In all likelihood, it will never be made explicitly at all. If so, all a court would have to review in determining whether the standard set in *Caremark* and *Stone* has been violated will be

the vague and unarticulated notions of the various directors concerning what they should have known about the corporation. There would certainly be no single, articulated standard set *ex ante*. The board's views in such a case will suffer from all the infelicities that a court's would in an *Allis-Chalmers* inquiry and will, in addition, be tainted with self-interest. Much better, therefore, to require the board to say explicitly what the standard should be before the case arises.

The rule I am proposing here, therefore, is more stringent for boards and more protective of shareholder interests than the *Caremark-Stone* rule, and is probably as stringent a rule as can practically be devised. That it is not too stringent, I think, follows from the fact that boards cannot reasonably object to being held to standards of reasonability that they themselves have approved *ex ante*. In providing clear *ex ante* guidance to boards, the rule may even be more friendly to boards than the *Caremark-Stone* rule. If the rule is neither too friendly nor too hostile to both boards and shareholders, it is likely the most efficient rule possible for such cases.

C. *Standard of Review When Duty of Care is Breached*

A question remains, however, as to what should happen under the rule if a board, in omitting to act, has breached its fiduciary duties of care, loyalty, or good faith.¹⁰⁹ As indicated above, if the omission relates to failing to detect and prevent illegal wrongdoing by corporate employees, the directors should be liable, for if directors knew or should have known about illegal conduct by corporate employees, the directors' duty to prevent such activity should be absolute. But if the omission relates, rather, to a missed business opportunity, the question is more complicated. I suggested above that, based on a symmetry with the business judgment rule as applied to deliberate decisions by the board, the court should review the omission for entire fairness. Especially if the duty breached by the board was the duty of loyalty or good faith (e.g., the board omitted to act in a case where a majority of the directors were interested in the omission), the entire fairness standard seems clearly right.

When the duty breached is the duty of care, however, and the omission concerns not preventing illegal conduct but merely a missed business opportunity, then there are reasons for thinking a substantive standard other than entire fairness might be better. Recall that, in the usual

109. In my view, a 102(b)(7) provision in the corporation's certificate of incorporation should shield directors from personal liability for their wrongful omissions in violation of the duty of care just as it shields them from such liability for all other breaches of the duty of care. See Del. Code Ann. tit. 8, § 102(b)(7) (2001); *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001) (dismissing complaint based on duty of care violation on basis of 102(b)(7) exculpatory provision in certificate of incorporation).

duty of care case, the board has taken some action that it believed was in the best interests of the corporation, but the plaintiff has proved that prior to making its decision the board had not gathered all of the material information about the transaction reasonably available. In such cases, it might seem natural to shift the burden of proof to the board to prove that the challenged transaction, in light of information reasonably available to the board at the time the decision was taken, really was value-maximizing. Maximizing value, after all, is what boards are supposed to be doing. But because courts are more competent with norms involving fairness than those involving maximizing value, the standard adopted on review is not whether the transaction was value-maximizing but whether it was fair to the corporation and its shareholders. It would seem, at first blush, that the same should be true for wrongful omissions to exploit business opportunities.

In the case of a deliberate decision made in breach of the duty of care, however, the court has a definite transaction actually effected, together with that transaction's unique terms and history, to scrutinize for fairness. When we try to evaluate mere omissions for entire fairness, we find that many of the doctrines that courts have developed to consider the fairness of transactions are not readily applicable to mere omissions. Some of those doctrines concern fair processes leading up to the transaction, and here, of course, there was no transaction and so no processes, fair or otherwise, leading up to a transaction. Other doctrines concern fair prices. The determination of fair prices, however, usually proceeds by familiar techniques of judicial determination of fair market value—comparisons with similar transactions in an open market, expert valuation testimony, and so on. In some cases, such techniques will work as well with omissions as with actual transactions. In many cases, however, such techniques will be very difficult to apply to counterfactual transactions that never occurred.

More to the point, however, is that an asymmetry between acts and omissions makes the entire fairness standard less apposite here. With a transaction actually effected, the law should not permit the directors who have breached their duty of care to impair shareholder value. Hence, the entire fairness standard seems right, for the legitimate interests of shareholders are presumably protected if the transaction was entirely fair. Even if the transaction was not value-maximizing, at least the shareholders have not been made worse off by the transaction relative to the *status quo ante*. With an omission by directors related to a missed business opportunity, however, the issue is not that the shareholders have been made worse off relative to the *status quo ante* but that they have failed to get a benefit that directors doing their jobs would have obtained for them. The difference is between acting contrary to the goal directors should be

pursuing (maximizing shareholder value) and failing to act vigorously enough in pursuing that goal. These are both failures on the part of directors, but they are distinct kinds of failures in living up to the norm that directors should maximize shareholder value.

If we think this distinction is important, then the rule could be that, once the plaintiff has proved that a majority of the directors breached their duty of care by not knowing what they should have in connection with the missed business opportunity, the burden shifts to the defendant directors to prove that it was reasonable to believe that, in the circumstances in which the omission occurred and in light of the knowledge the directors ought to have had at the time and all further knowledge they actually did have, exploiting the business opportunity was *not especially likely* to be value-maximizing for the corporation. The directors would have to prove, in other words, not that the omission was fair but that it is reasonable to think that they did not miss an opportunity to make a killing. Given the wide latitude that directors are supposed to have in managing the business, even when they have breached their duty of care by not knowing what they should, it seems right that they should be liable for missing business opportunities only when any competent director would have wanted the corporation to pursue the opportunity had he or she known about it. The proposed rule captures that intuition.

D. Adapting the Process-Model to Director Omissions

To summarize, the process model of the Delaware business judgment rule can be adapted to apply to wrongful omissions of corporate directors as follows.

A board of directors may by resolution set forth what knowledge about the corporation directors should have. Such a resolution would normally include some *per se* rules requiring that directors be familiar with the contents of the corporation's organizational documents, financial statements, and filings with the Securities and Exchange Commission, and would provide for the creation and maintenance of a corporate information and reporting system as generally reported on under Section 404 of Sarbanes-Oxley—all as the board thinks is reasonable (i.e., cost-justified) in relation to the actual facts and circumstances of the corporation. The scope of knowledge required of corporate directors in omissions cases would be determined solely by this board resolution, as the same may be modified by the board from time to time. The adoption of such a standard would be reviewed under the business judgment rule. If a board fails to adopt such a resolution prior to a challenged omission, then the court will decide for itself whether or not the board should have known about the facts related to the omission.

In any suit seeking to hold directors liable for their mere omissions, the burden shall first be on the plaintiff to show that the directors breached one of more of their fiduciary duties in connection with the omission. The plaintiff could show (a) a breach of the duty of loyalty by showing that the directors were either interested in the omission or lacked independence, (b) a breach of the duty of good faith by showing that the directors actually knew they should have acted and did not, or (c) a breach of the duty of care by showing that the directors did not have some of the knowledge that the board's resolution determined that directors should have. It would be a question of fact for the court to determine whether individual directors actually had the knowledge the board's standard-setting resolution required that they have.

If the plaintiff fails to carry this burden, then the directors' failure to act will support liability only if the failure can be attributed to no rational business purpose. Equivalently, the omission to act will stand unless any rational businessperson knowing what the directors knew would have concluded that maximizing shareholder value required the board to act. Permitting the corporation or its employees to violate the law, however, can never serve a rational business purpose, and so directors who know or should have known of such violations will have an absolute duty to stop them. On the other hand, if the plaintiff carries its burden and shows that the directors breached one or more of their duties of care, loyalty or good faith, then the burden will shift to the defendant directors to prove that the omission was entirely fair to the corporation. In the alternative, if the breach was of the duty of care and concerns a missed business opportunity, then the burden will shift to the defendant directors to prove that it is reasonable, in light of the knowledge the directors should have had at the time and any additional knowledge they actually did have, to believe that the omitted action was not especially likely to be value-maximizing for shareholders.

This rule satisfies the desiderata set forth at the end of Part I. In particular, it is consistent with the theory underlying the business judgment rule that the best long-term protection of shareholder interests is the informed judgment of honest businesspeople free from conflicts of interest. At no point does the rule substitute the judgment of courts for that of businesspeople concerning business matters. It does allow for a judicial determination *ex post* of whether such businesspeople have lived up to a standard for being informed that such businesspeople set for themselves *ex ante*, but that is not to substitute the court's business judgment for that of businesspeople. Moreover, determining whether a party met a pre-determined standard is precisely the kind of inquiry for which courts are well-suited.

Further, the rule is entirely process-based. Under the proposed rule, a

court trying a case based on an allegedly wrongful omission by a board considers not the business merits of the omission but the process leading up to it—in particular whether the board knew all that it should have known at the time of the omission. If the process was good, the only inquiry regarding an omission is the same inquiry regarding a deliberate decision—whether the omission can serve any rational business purpose. Finally, the rule also strongly encourages good process by giving the board a strong incentive to think ahead of time about what it should know about the operations of the corporation. For, if the board fails to consider this issue and set forth its conclusions in a board resolution, the court will make this determination for it *ex post*, thus exposing directors to the uncertainties of litigation.

IV. CONCLUSION

The primary issue addressed in this article is how a process-based standard can be applied to omissions. The problem looks insoluble at first because omissions seem by definition to have no process underlying them. The solution lay, in effect, in expanding the notice of process: a board uses good process prior to an omission if, generally speaking, it knows all it should about its corporation at the time of the omission. That solution itself generated a new problem, for what a board should know depends very heavily on the particular facts and circumstances of the corporation and inevitably involves business judgments about which information and reporting systems produce benefits in excess of their costs. The solution to this latter problem lay in splitting the determination of whether directors knew what they should have known into two parts—the creation of a detailed standard, which has to be carefully tailored to the circumstances of the particular corporation and involves business judgment, and an inquiry into whether directors in fact lived up to that standard. The first is something a board of directors can do, the second something a court can do.

The Delaware courts, in my view, have generally done an excellent job of monitoring corporate boards by concentrating on process. In *Stone*, however, they overlooked the possibility of developing a process-based standard to handle the problem of wrongful omissions by corporate directors, “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”¹¹⁰ I have attempted to show that the possibility of a process-based standard is a real one. Its adoption in Delaware would rationalize the law by treating wrongful decisions and

110. *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006) (quoting *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. 1996)).

wrongful omissions on the same basis, and it would protect shareholder interests better than the solution the Delaware Supreme Court settled on in *Stone* without imposing any new or undue burden on the board.