

Conference Panel Discussion

The Business Judgment Rule*

Prof. Kozyris: First, I want you to know that this Conference was the brainchild of Professor Bill Cary and our Dean Jim Meeks. Bill helped select the topics and was eager to come and join the debates until the aggravation of his illness and untimely death. He was one of the giants in our field and it is fitting for us today to pay tribute to his memory. Jim was actively and enthusiastically involved in putting this Conference together and he would have been here today had it not been for a serious traffic accident which has kept him in the hospital. All of us on the panel and, I am sure, all of you down there wish him speedy recovery.

Our discussion today will focus on the so-called "business judgment rule," a judicially developed law concept that the business decisions of corporate management should not be second-guessed by the courts. The courts will not interfere with such decisions as they are being made and carried out, nor will they impose liability on management if it turns out that the decisions were wrong.

Recent corporate practices, especially defensive measures by corporate boards to fend off takeovers, and terminations by disinterested boards or committees of derivative suits involving foreign bribes, have rekindled interest in the purpose and scope of the business judgment rule and have contributed to its refinement and clarification. Some of the controversial topics include the relationship between the rule and the duty of care of management, especially in the context of the monitoring role and responsibilities of outside directors; and the exclusion from business judgment protection of decisions affected by conflicts of interest, or pursuing improper purposes, or not involving "management of business" matters.

Dean Manning's article eloquently presents the issues and apparently expresses an agnostic position. I detected a certain degree of sympathy for the protective aspects of the business judgment rule. By how they delineate its scope, one may classify some persons as greater supporters and others as lesser supporters of the rule. That's not an easy line to draw. We will follow up now with a brief commentary by Professor Frankel, who will discuss how, if at all, the business judgment rule can be reconciled with the fiduciary obligations of management.

Prof. Frankel: I have a somewhat different scenario than the one presented to you by Professor Manning. The players are not Mr. Smith and Ms. Jones. They are Tom, Dick, and Harry. To them, the business judgment rule serves as an ideological battleground. And here is what Tom would say. Management is the controller of the corporate enterprise. This view, he would say, is supported by those economists who maintain that management is entitled to the residue of the corporate assets after the

* The panelists were moderator P. John Kozyris, Professor of Law, The Ohio State University; Richard M. Buxbaum, Professor of Law, University of California, Berkeley; Tamar Frankel, Professor of Law, Boston University; Harvey J. Goldschmid, Professor of Law, Columbia University; Robert W. Hamilton, Professor of Law, University of Texas; Alan Schwarz, Professor of Law, Rutgers University at Newark; Phillip C. Sorensen, Professor of Law, The Ohio State University; James M. Tobin, Partner, Squire, Sanders & Dempsey, Columbus, Ohio.

claims of the employees, shareholders, and creditors have been satisfied. In England, for example, originally a corporate office was a species of property. It was later that it was converted into a fiduciary position. I doubt that this theory was ever applied in this country, but I do contend that corporate power is not held in trust. It is vested in management and management is entitled to use it as it wishes, subject to the limitations imposed on it by contract, and subject, of course, to market constraints. Now the corporation as I view it is an aggregate of contracts in which people negotiate their compensation, their benefits, and the powers that they will exercise during their tenure. The corporation is a mini-market. No more, no less. Management should therefore determine the purposes and the business policies of the corporation. My conclusion is supported by judicial precedent. The courts have merely decided on a very high level of generality that the purpose of a corporation is to engage in economic activities for profit—and I agree. These decisions also vest in management the power to determine the size of the corporation, by permitting it to reinvest corporate profits instead of distributing them to the shareholders. In addition, management's discretion was further broadened by certain decisions in the 1950's which permitted, but didn't require, management to take into consideration socially desirable policies. Corporate management powers were supported by decisions which permit management to use corporate assets to buy out dissenting shareholders, to campaign actively for reelection, and to ward off takeover attempts subject to some distinction between personal ambition and business policies; these distinctions don't really withstand rigorous analysis.

The business judgment rule is supportive of my position as well. It shields management in the performance of its duties and the use of its power so long as management acts honestly. The rule not only protects from liability, it protects also from judicial scrutiny. The rule is fine.

Dick has a different view. He says: Management is a fiduciary. Its power is power in trust. This power is granted only for the purpose of enabling management to serve effectively. The power must be used exclusively to further the corporate purpose. As fiduciaries, managements must be accountable to someone other than God or their consciences. They are not selfish actors restrained against their will by some outside forces, such as the market. They are actors for the shareholders, morally and legally bound to act for the shareholders, and accountable for their actions. Managements may be accountable to the courts, to shareholders, to government agencies, to internal independent groups, to others. Judicial supervision should increase if alternative controls fail, and it should decrease as alternative controls are strengthened.

I maintain that the only purpose of the business judgment rule is to permit management to take calculated entrepreneurial risks but, unfortunately, the rule has been extended beyond that purpose. Business has been defined to include all decisions that management is authorized to make. The broader management power became, the greater protection it obtained under the rule. Furthermore, honesty is viewed to cover any decision that does not involve direct pecuniary benefits to management. The opposite should have occurred. Greater power should be accompanied by more, not less, supervision.

It has been argued that business requires flexibility and fast decisionmaking, but I am not sure that management in large corporations engages in split-second decisions. I think the decision to launch or even to ward off a takeover takes a little longer. And large corporations don't move fast. Consequently, the business judgment rule should be limited to those decisions which involve frequent, day-to-day operations by the company and require immediate action.

It has also been argued, and we heard the same argument here, that the courts don't have the expertise to evaluate business decisions. I question that. Courts have decided cases of great economic complexity in the antitrust area, and they have been supervising reorganizations of large corporations, which also require substantial expertise. In addition, courts analyze in detail transactions which they would exclude under the business judgment rule when these transactions involve self-dealing. I, therefore, come to the conclusion that the court should design a flexible business judgment rule, exclude only day-to-day operations, and play a more active role in supervising management and setting the standards which it should follow.

And here comes Harry. He says: The large corporation represents so many contradictions. Look at it. We have personified it and treated it as an individual, and yet in reality it is an enormous organization. It acts in the private economic domain, and yet it wields power greater than many states. We regulate its managers under private law, and yet their activities affect the country and the economy, not only a few individuals, principals, and beneficiaries. The corporation is an invisible part of our governmental structure, and yet it is not bound by constitutional constraints but rather protected, at least partially, by the Constitution. The corporation and its managers should be accountable, but our political philosophy tends to avoid government as a policymaker for economic policies; and our economic policy tends to give managements incentives to act as entrepreneurs. Above all, litigation is costly. It focuses on one or few transactions rather than patterns of behavior.

Perhaps courts may take on an ongoing role of supervising. They've done so in trust cases; they've done so in bankruptcy; they are beginning to do so also by way of declaratory judgments. Management could then resort to these courts before, not after, it makes the policy decisions and obtain a safe harbor. Or we may develop some kind of legislative-type board—a roundtable with boards' representation. I think we should continue to talk. Management must understand that its legitimacy depends on accountability but the rest of us must agree that we have not yet found the mechanism to achieve it.

Prof. Kozyris: Thank you, Professor Frankel. Next in order, after exploring the parameters and the problems of the rule, we felt that we ought to bring you up to date on the two major current attempts to refine and define the rule and the concept. First, the *ALI Restatement and Recommendations*¹—a very interesting hybrid animal—and second, the ABA revision of the Model Business Corporation Act.² So we asked

1. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) [hereinafter cited as PRINCIPLES OF CORPORATE GOVERNANCE]. A new draft of this document incorporating significant changes appeared in 1984.

2. REVISED MODEL BUSINESS CORP. ACT (Exposure Draft 1983). The definitive text of the MBCA was adopted in 1984.

Professor Goldschmid of the Columbia Law School, who is one of the prime movers or architects in the ALI effort, to enlighten us on how they approach this difficult area. Professor Goldschmid?

Prof. Goldschmid: I am going to build on Bay Manning's elegant presentation. I don't intend to debate with Bay or to describe in detail the ALI formulations, although I'd be delighted to answer specific questions if they are raised during the question period.

Let me start by embellishing a bit on Bay's wonderful dialogue between Mr. Smith and Ms. Jones. Parenthetically, I would like to say that I found a great deal of wisdom in Professor Frankel's discussion of Tom, Dick, and Harry. Let me add to Ms. Jones' case in the following way. First, I believe that in large measure corporate directors and officers properly carry out their corporate responsibilities for reasons unrelated to law. A personal sense of responsibility, economic or career incentives, pride, professionalism, and peer pressure obviously play a role; discipline is certainly instilled by competitive markets and markets for control. A second basic premise of Jones' is that we should not be unduly harsh to directors and officers. I agree. We certainly don't want to chill the willingness of those with wisdom, ability, and expertise to serve the modern corporation. Finally, with Jones, and I think this is critical, we don't want to unduly hinder risk taking, innovation, and other creative entrepreneurial activity.

Speaking with Mr. Smith's hat on, I must raise that vague—but most important—word “accountability.” In this context, for example, “accountability” means independent board review of the modern corporate manager. Why do we need such review? In a piece I did several years ago with Professor William L. Cary,³ and I'll just be able to touch categories, we listed the following categories of concern. First, without independent oversight, capricious corporate decisionmaking is encouraged. A particularly horrible example, of course, was the well-documented collapse of the Penn Central, where there was very little board review of any kind. There are too many other modern examples. Dean Courtney Brown of the Columbia Business School, who spent over two decades on some of the nation's most important boards, stated:

[A] single major blunder of judgment can damage an enterprise seriously. It would be interesting to know the extent to which write-offs, ranging from \$100 million to \$500 million, that have been recorded in recent years . . . stemmed from the dominant influence of one decision maker. Or, in a different type of situation, a head man's prolonged lack of imaginative leadership or judgment can result in the gradual erosion of the organization's vitality over a number of years.⁴

Courtney Brown urged attention to the “check-and-balance” function of the board.

Now a second major category of concern. Managers may misallocate corporate resources because they have somewhat different interests than the shareholders they theoretically serve. Managers may favor growth as opposed to long-term profit

3. Cary & Goldschmid, *Foreword to the Corporate Social Responsibility Symposium: Reflections on Directions*, 30 HASTINGS L.J. 1247 (1979).

4. C. BROWN, *PUTTING THE CORPORATE BOARD TO WORK* 16 (1976).

maximization. They may succumb to the temptation to maximize short-term profits (while they are in office) at the expense of the shareholders' long-term interests. Independent board oversight provides a nongovernmental, private sector stimulus which encourages efficiency-oriented corporate decisionmaking.

A third major concern was that managers might succumb to inherent conflicts of interest. Compensation questions and interested director or officer transactions jump immediately to mind. More subtle, but similar, issues are raised when managers make decisions (with their careers at the corporation at stake) during the course of a hostile takeover attempt.

Each of these concerns leads me to favor independent board review of modern managers. An appropriate role for the law is to create incremental incentives for such oversight by independent directors. More generally, for well over 100 years, courts and legislatures have considered legal standards with respect to duty of care to be a necessary protection for corporations and their shareholders. As is true of professionals and almost all others in our society, the accountability of directors and officers is a legitimate public policy concern. As the Supreme Court of New Jersey recently put it, "Shareholders have a right to expect that directors will exercise reasonable supervision and control over the policies and practices of a corporation. The institutional integrity of a corporation depends upon the proper discharge by directors of those duties."⁵ I believe that similar policy concerns underlie the Second Circuit's recent decision in *Joy v. North*⁶ and the Fifth Circuit's decision in *Meyers v. Moody*.⁷

Where does this lead us with respect to duty of care and the business judgment rule? How are we, for example, to protect directors from unfair, hindsight reviews of their unsuccessful decisions while encouraging proper board activity?

Let me briefly provide a "feel" for the ALI formulations, which are still being drafted and reviewed and are most accurately described as "reporter" formulations rather than "Institute" formulations at this time. In response to criticism (such as that offered by Bay) that the law does not now define what a director is supposed to do, the ALI drafts do in fact provide realistic guidance. Traditional corporation statutes command directors to "manage" the corporation, and more recent statutes simply require that the corporation be "managed under" the board's direction. These statutes have assigned the board a number of specific tasks (*e.g.*, the approval of mergers, the declaration of dividends), but have not provided guidance as to such matters as the board's core functions or the functions of important committees. In combination, Parts III and IV of the ALI's Corporate Governance Project, in my view, provide directors and officers with a more precise and sensible picture of their functions than has ever been provided before.

In many ways, the ALI drafts intentionally afford protection to directors and officers. The ALI drafts recognize that directors and officers should not be asked to ensure that every potential corporate problem is anticipated or that every instance of

5. *Francis v. United Jersey Bank*, 87 N.J. 15, 36, 432 A.2d 814, 824 (1981).

6. *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

7. *Meyers v. Moody*, 693 F.2d 1196 (5th Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

wrongdoing (*e.g.*, looting by an employee) is prevented. Indeed, the complexity and scale of many modern corporations compel directors and officers to rely heavily on other directors or officers, employees, and experts, and the ALI drafts broadly provide for such reliance.

Similarly, the ALI drafts recognize that the fact that directors (and sometimes officers) act as a group has important practical and legal implications. In becoming informed with respect to the subject of a business judgment, for example, directors (in addition to drawing on their own background) are told that they may learn from, or rely on, discussions of other directors as well as management presentations. To meet the points that Bay has raised, the ALI drafts stipulate that the different backgrounds of individual directors, the distinct role each plays in the corporation, the value of maintaining board cohesiveness, the magnitude of the matter under consideration, the time frame in which a decision must be made, and similar factors are all relevant in judging whether a director has acted properly.

The ALI drafts also recognize that since the business judgments of the board are not decisions of individuals and since oversight obligations rest on the board as a whole, difficult proximate causation issues will often arise. A director who fails to perform an oversight obligation, for example, may have caused no damage to the corporation because the failure was rendered harmless by the reasonable care of other directors.

Finally, the ALI drafts (in the formulation of section 4.01(d)'s business judgment rule) provide special protection for informed business judgments as distinguished, for example, from continued inattention to directorial obligations. The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove them right or wrong) in order to stimulate rational risk taking and venturesome business activity. The special protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private sector business decisionmaking.

The business judgment rule set forth in the ALI drafts⁸ is a proposed gloss on duty of care standards that sharply reduces exposure to liability. The ALI's draft business judgment rule is believed to be consistent with present law as it would be interpreted in most jurisdictions today, and each of the rule's basic elements is supported by substantial precedential authority. What has heretofore been the most controversial element of the formulation—the "rational basis" test—is intended to permit directors and officers a significantly wider range of discretion than the "reasonable business judgment" test used in some cases. On the other hand, in my view, courts that have articulated only a "good faith" test provide too much legal insulation for directors and officers. I see no reason to insulate an objectively irrational business decision—one removed from the realm of reason—solely because it was made in subjective good faith.

As I hope that I have indicated, I share Bay's view that there is—and should be—more than a little of both Ms. Jones and Mr. Smith in all of us. In what is a most

8. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 4.01(d).

serious and responsible undertaking, I think that you will find that in the new ALI drafts (which should become public next spring) the Institute has struggled hard to draw the right public policy balance.

Prof. Kozryis: Thank you, Harvey. Next, Robert Hamilton of the Texas Law School, one of the two professors involved in the ABA revision of the Model Business Corporation Act, will give us the benefit of his and their insights on this thorny issue.

Prof. Hamilton: Unlike the ALI project, the ABA revision of the Model Business Corporation Act has had, I think, lawyer dominance, practicing lawyer dominance, with only two law professors participating. I suppose that is the way that it should be. After all, this is a statute that is recommended for adoption by the states. In the past, it has been adopted in some thirty-five states in whole or in part. One obviously should not get far ahead of current thinking. The Model Act provisions dealing with the business judgment rule are sections 8.30 and 8.31, which is the duty of loyalty. When I reflect on Bay's positions, I think it is clear that our disagreements are most profound in the duty of loyalty area, not in the due care cases.

I should perhaps say that the new Model Act will be in the form of a statute with fairly brief sections, similar to the present Model Act provisions, followed by an official comment ranging from a paragraph to several pages in length explaining the alternatives, giving examples in some cases, giving suggestions as to how the section could be utilized.

In connection with the duty of care, there has never been any controversy about the statute itself, that is old section 35, now numbered section 8.30. The amazing phenomenon has been in the official comment, which has had a life of its own essentially unconnected to the black letter to which it relates. Marshall Small, who is now on the committee as well as on the ALI Corporate Governance Project, strongly urged that we codify the business judgment rule in the official comment, and he prepared a draft that went through numerous revisions and was incorporated in the exposure draft. There have been mutterings of discontent within the committee ever since things came to a head last spring when we had a subcommittee meeting at which there were five or six people sitting around. The chairman of the subcommittee said, "Now, let's each of us say what we think we have here in section 8.30." For the next two hours I sat and listened as at least five different, totally different constructions of what the section and official comment meant were put forward. It was apparent at the conclusion of the speeches that what had happened was that the language had papered over very substantial disagreements among a variety of different people and that some rather drastic changes were in order. What is likely to happen with respect to section 8.30 is that the comment will be neutral and will say: "We realize that there is something called the business judgment rule. We do not know what it is or how to define it but courts, go ahead, you keep on applying it and we will try to codify it at a later date." Not a bad solution to what is a very difficult problem.

Now when we move over to the duty of loyalty cases, as Bay described them, including the tender offer problem, the litigation committee, the classic conflict of interest where the director sells a piece of land to his own corporation, and the application of the business judgment rule in those situations, I find I have a rather

different approach from Bay's toward the problems. In a sense, I suppose the issue comes down to what do you mean by disinterested director. How disinterested do you have to be to be disinterested? I think that what Bay does is to take the very best, most disinterested board of directors that he knows and says, "See, all boards of directors are like this. Therefore, we can apply the business judgment rule to decisions by disinterested directors." In fact, as he recognizes in a different context, boards are complex and variegated; some directors are independent, some directors are not. The proposal to apply the business judgment rule broadly across these conflict of interests transactions, in other words, limiting the role of the court review of conflict of interest decisions solely to whether or not the committee or the board was disinterested, in effect will result in no judicial oversight of decisions at all. We will have withdrawn a very substantial degree of protection that now exists in connection with conflict of interest transactions. Perhaps Bay disagrees with my characterization of his position, but his views expressed to the committee on corporate laws and the views of many other practicing attorneys start from the premise that the world is like our very best board of directors. I don't think in drafting a statute, or establishing a broad rule of decision, one can assume the world is like what the best is. I suspect one should start from the opposite premise, and I think that may well be where we disagree.

There is in the *Harvard Law Review* that came across my desk a few weeks ago a student comment which puts a different perspective on the litigation committee issue.⁹ It argues that in the theoretical study of group dynamics—how groups make decisions and how individuals make decisions—the empirical study of group dynamics indicates that there is no such thing as a disinterested director on the board of directors. The author suggests that the pressures are such that those disinterested directors in fact will do what management wants or will do what they think the group wants in the overwhelming majority of cases. Now I tend to scoff at the economic teachings in this area, on the ground that they involve complex problems being analyzed fairly simply. I suspect the same criticism can be made about anyone who relies on a study of group dynamics for determining how independent directors make decisions. I would think, however, that Bay's position—that there should be a business judgment principle permitting dismissal of conflict of interest claims—has to argue that that whole branch of study is irrelevant. If it has any validity at all—not if it's totally valid but if there's any validity at all to it—it follows that we do need a continued judicial review of some sort over decisions to dispose of conflict of interest claims.

I did not find myself in either of Bay's two people. I found myself halfway between them. I think that where you have a board, a committee, or a group that appears to be independent, any court should give deference to their decisions to do or not to do something. I don't have any trouble with that. Where I do have trouble is the position which I understand Bay is putting forward that the only issue that the court should examine is whether the committee is disinterested in some undefined way, and

9. Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983).

if it is, all inquiry stops at that point. I think that there is rather a fundamental policy difference between the way I look at this problem and the way I understand that Bay does.

Prof. Kozyris: Thank you, Bob. It's interesting to note that the ABA effort appears to be moving faster than the ALI. They had a lead, a starting point. I want to alert our Ohio people here that our formulation of business judgment, the present formulation, is about identical with the MBCA, and so I wonder to what extent the revision will have great relevance for Ohio, assuming we are more influenced by the MBCA than by other sources. Next is Professor Alan Schwarz of Rutgers and formerly of Ohio State for many years. I remember when I was a novice teacher here, any time I had a difficult problem I knew where to go to be not only enlightened but also challenged. So now that we have a difficult problem, I thought of him as quite an appropriate member of this panel. How do we apply business judgment, Alan?

Prof. Schwarz: I take it that if a director or an officer makes a mistake and has no personal interest in making that mistake and the court thinks it really is a mistake, it will protect each of them against a certain range of such mistakes. But if what was done appears to be a mistake or is a mistake and the director has a personal interest in making the mistake, then I think the court is saying, "We don't really believe it was a mistake. You weren't negligent in doing that. You did that because you had an interest in diverting shareholder wealth or shareholder opportunities to yourself." Now in that context, I believe, and I certainly can't prove this empirically, that when a board refuses a merger offer on very attractive terms or where a board takes active steps in opposing or thwarting a tender offer I don't believe that the board is making a mistake. I simply ask myself what would I do if I were a disinterested director; and if I were a disinterested director I would support management or resign. At some point I would resign, but I doubt very much if I personally would blow the whistle, and although my morality is not of the highest, it may not be of the lowest. And therefore I ask myself, if I know this, how come courts don't know this? And how come courts say there's no conflict of interest when obviously there is a conflict of interest? And then I speculate that maybe they really know what I know and there are some underlying problems which lead them to conclude there's no conflict when in fact there is a conflict. I want to speak briefly on what may be some of these underlying problems.

I'm not sure that we're really talking about conflicts in business judgment when we're talking about director's responses to merger offers. Rather, we're talking about the substantive principle of to what extent directors have an obligation to shareholders as opposed to an obligation to officers and managers who are acting legitimately, by which I mean they are seeking to maximize shareholder profits. It's simply that some other group for one reason or another can do a better job of that. And I wonder to what extent the courts aren't saying that the so-called disinterested directors who turn down the merger—because agreeing to the merger would be turning out these people who are not incompetent, who are very competent—should be protected even though for some reason of synergy or some other reason, these assets happen to be worth more to someone else than they are to the present owners of the enterprise. To the extent, of course, of doing that they're not really talking about conflicts; they're not

really talking about business judgment. They're talking about the legitimacy of a property interest of management in management. That's one possibility.

A second related possibility which I think Jim Tobin would appreciate is that one of the reasons that management is turning down the merger is that they're not solely concerned with the power position of the existing board or the existing insiders. Rather, they are concerned with the village or the community and that the outsiders are less likely to be. Instead of confronting what is essentially an impossible problem of how a court allocates legitimacy as between opposing claims to legitimacy, it simply talks about no conflict and business judgment. But again, it's really saying something quite different.

A third possible speculation about these cases is that, as Dean Manning suggested, assuming we don't apply the business judgment, what do we do? Ordinarily, if we don't apply the business judgment rule, then we determine whether the deal is fair. And if the deal is unfair, consequences attach. There are two difficulties with that in respect of a takeover situation. First of all, it seems too easy. If you believe in efficient capital markets, and I don't know of any other rational way of focusing on fairness except by focusing on efficiency of capital markets, then definitionally the deal is fair and definitionally turning it down is outrageous because anything that is above the present market price is higher than what the assets are worth. The difficulty with that principle as applied here, however, is that the shareholders don't agree with it. Maybe they are wrong in not agreeing with it, but these shareholders, collectively, do not. They wouldn't buy their stock otherwise. They believe their investment will go up more than the rate of inflation or they wouldn't buy the stock. Therefore, they want management to act irrationally if rationality is defined in terms of efficiency of capital markets. I suggest, then, that the court would have the obligation to determine the fairness of the deal, focusing on speculative factors, and that is probably too difficult for a court to do.

Finally, there is a difference between the response to a takeover bid and a general conflict of interest situation. You have the difficulty of determining fairness on all conflict of interest situations, but it isn't a great problem because the directors always have the alternative of not dealing. Because fairness is very difficult to determine, if they're conscientious they ordinarily simply will not deal except on salary. But in this area the directors have no choice but to deal, because they do not trigger. They don't go to someone and say "make me a deal that I will refuse." The third party makes the deal and it's part of their responsibility to say either yes or no. Therefore, they do not have the out that the ordinary director has in the conflict of interest situation, and on those grounds, I would certainly distinguish between the director who simply says no and the director who then in addition to saying no goes out and attempts to thwart a tender offer. He has no responsibility to do that. He simply can give whatever information he believes is pertinent to the shareholders and let the shareholders decide, because under conventional corporate law it is the shareholders' decision and not the board's decision as to under what circumstances they should sell their stock.

Prof. Kozyris: Thank you, Alan. Next is Professor Phillip Sorensen of our College of Law who is also one of the founding fathers in the corporate responsibility movement.

Prof. Sorensen: There are now so many characters in this play—Jones, Smith, Tom, Dick, Harry, and Zubin—that I've lost track of which one I support. Let's just say that I stand with Socrates, wherever he stands. Awaiting word from him directly, I will proceed by telling you what I believe his position to be.

When I last taught corporation law some six years ago, I recall being impressed with the similarity between the business judgment rule and the tort doctrine of unavoidable accident. Most of you know that doctrine. Good defense lawyers usually request it as an instruction in negligence cases. The doctrine states that the mere occurrence of an accident is no proof of negligence. The business judgment rule seems to me to present the same idea only in the business context; that is to say, that the mere occurrence of a business deal gone sour is no proof of negligence.

The unavoidable accident doctrine will work to protect tort defendants less often than business directors for the reason that rules of the road are far more detailed than business rules. Business rules cannot, as Dean Manning has pointed out, be so encompassing or explicit. But this difference goes only to the scope of the two doctrines' effect and doesn't determine the basic analogy.

This year, as I reenter teaching corporate law, the comparison between the two doctrines seems even more apt. The unavoidable accident doctrine has been described just recently by Speiser¹⁰ as "an ingenious but disingenuous ploy that has plagued lawyers and courts for decades."¹¹ These same words can equally be applied today to describe the business judgment rule—although the plague has not been so long with us. Unlike the business judgment rule, however, the unavoidable accident doctrine has fallen into judicial disfavor. California and other states have rejected the doctrine as serving no useful purpose. Other jurisdictions have been reluctant to employ it, finding that it creates more confusion than clarity, more prejudice than enlightenment. So, unlike Dean Manning, I believe this is a time and a place where business law can go to school on tort law.

The cause for confusion in the unavoidable accident doctrine and in the business judgment rule is that both do no more than deny liability without proof of a violation of some legal duty. Neither doctrine is intended to establish that duty. One court, commenting on the unavoidable accident doctrine, said that it serves only to twice tell the jury that the plaintiff cannot recover unless he proves negligence. Neither doctrine is a substitute for standards of care or fiduciary duties.

Both doctrines have been occasionally justified, and I think that this is the only proper justification, as being explanatory of the standard of care required. This explicative power is overshadowed, however, by the impression each gives that they raise a separate issue. The business judgment rule has often been treated as something distinct and substantively different from the consideration of whether or not a duty has been violated. As such, it has pushed aside an adequate consideration of that duty—of the applicable standards of care (see *Treadway*¹²), or the criteria for undivided loyalty (see *Auerbach*¹³). In the ALI's Principles of Corporate Governance

10. S. SPEISER, L. KRAUS & A. GANS, *THE AMERICAN LAW OF TORTS* (1983).

11. *Id.* at 781.

12. *Treadway Co. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980).

13. *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

tentative draft, the business judgment rule is offered in effect as a substitute standard of care—a rational basis standard. More precisely, the ALI draft first establishes a duty of care of that of an ordinarily prudent person, and then effectively retracts this standard under what it perceives to be the protective shield of the business judgment rule. Twice, in the comments to the draft, it is argued that to fail to give the business judgment rule such a supplementary role would be to make the rule superfluous. The comments are, of course, correct—the rule *is* superfluous—and the ALI should have stopped with this observation.

The 1983 draft of the Revised Model Business Corporation Act does not make the same mistake although it does reach much the same result. The Revised Act offers the shield of business judgment if and only if the standards of care are first met. I think that this is all the business judgment rule, if it can even be called a rule, should do.

I find myself somewhat ill at ease making an argument that superficially has an appeal of only academic neatness. My argument, however, goes beyond a preference for orderly approaches. I am opposed on policy grounds to the recent trends toward further immunization of directors. I am opposed to Zubin Mehta being on a board of directors if he has nothing to contribute by way of oversight. I need not apologize for not wanting Zubin Mehta as the pilot in my airplane or as the director of my corporation. I also am not opposed to second-guessing persons in responsible positions. I'd be out of a job if I were. I think most duties of care, most legal duties, lack explicit standards, and this shortcoming does not justify their elimination. In any event, I believe that the recent trends toward diminishing the responsibility of officers and directors has occurred in part simply due to the confusion created by the business judgment rule. Its back door approach has avoided a forthright consideration of what duties ought to be imposed on officers and on directors. The business judgment rule ought not to be used to nullify the duty of care or the duty of loyalty. The rule simply should not serve as a ruse, albeit unwittingly, to reduce the standard of care to "some rational basis" or to narrow the criteria for conflicts of interest. If those are the objectives to be sought, then they ought to be addressed directly. To paraphrase a familiar saying, I believe the business judgment rule should reign but not govern.¹⁴ Better still, it ought simply to be discarded so that we might return to focusing on the issues of directors' duties and standards.

Prof. Kozyris: Thank you, Phil. After you heard so many academic commentators you are now entitled to an undiluted practitioner, a distinguished practitioner. Jim Tobin, a partner in Squire, Sanders & Dempsey here in Columbus, is finding himself most of the time in the crucible of conflicts in the most controversial areas of corporate law where the rules we're talking about find application. He is to discuss the application of the rule in discreet situations, putting it to the test in that context.

Mr. Tobin: Thank you, John. John's charge was to apply the business judgment rule to controversial subjects, especially the defense of control. Several members of

14. J. Zamoyski, Speech in the Polish Parliament (1605), in J. BARTLETT, FAMILIAR QUOTATIONS 167 (E. Beck 15th ed. 1980).

the audience have suggested to me that I use this opportunity to discuss the federal-state issues as they affect the Ohio legislation because of my role as quarterback of the legislation. We don't have time to do that. Tomorrow morning Morgan Shipman and I will be addressing all of these issues at the State Corporate Counsel Institute meeting at Deer Creek Park, so if you would like to see the hills and the fall and to listen to Morgan and I where we will be better able (because we're out of town) to play the role of experts, I invite you to hear us there. Morgan has played an extremely important role in the development of the Ohio legislation. He was one of the key people involved in the development of the policy questions, and I would have to say that I owe him a special debt apart from his brilliance because he served as the keeper of the conscience for some of my more defense-minded colleagues. He helped me in keeping a balanced approach to the thing which was of course our goal in doing it—to stay alive and well.

This brings us to the question of where does all of this fit into the business judgment rule. About eleven months ago before Chairman Shad focused on our legislation I was having lunch with a highly placed SEC staff member. After he had reminded me that he had always told me that the state takeover statutes would go down on a commerce clause basis, and applying that wisdom to our present Ohio legislation, we got down to the policy questions in which he confessed that he really felt after long consideration that there should be someone on the defense side of a control acquisition who could deal with the person making the bid, and that could only be the board of directors of the defensive corporation. While it was praiseworthy to consider votes of shareholders, the first wave of defense for a corporation in connection with the transfer of control necessarily had to be the board of directors. The problem in his mind was that he was not satisfied that the business judgment rule and the gloss of corporate law were sufficient to establish accountability for directors in the crucible of a tender offer. The question was how can we deal with those issues. Now, this is a very reasonable man, a very wise and learned man, a very rational man, and I think the fact that he has that concern is something that we have to give serious consideration to. One of the commissioners, Commissioner Longstreth, in discussing the going-private situation was recently quoted as saying that review by nonmanagement directors is faulty because they often fail to look out for the interest of public shareholders. While this was in the context of going private, which is a little tougher issue, I think this is the kind of thing that is being said by many people. It has been echoed here today; it was yesterday; and I think it underscores what Mel Eisenberg said yesterday that whether or not there is indeed sin here, there is the perception of sin. We should be dealing with the perception of sin itself, whether or not the sin exists. Bayless has pointed out that in terms of development of new standards there are none on the table, and I would be frank to say that I don't have any answers to what the new standards ought to be. I have not heard anything here today which has led me to believe that anybody is prepared to drop the draft on the table. This is probably why when we developed the last part of our control acquisition legislation—which was an authorization for charter amendments to empower either directors or shareholders to review control acquisitions—we used a broad brush in doing that, because we weren't prepared to give those answers. And I think our

feeling was that perhaps they were best hammered out in the crucible of an actual shareholder vote on it, and a reorganization of the corporation, and the fights that would necessarily be involved in that—or in the battles of underwriters when you are making an initial issue of a public offering involving restrictions on transfer of shares—given directors would have some role reviewing a transfer. We have left that issue open.

Our offices have tried a couple of shots at it—one involving an initial public offering, the other a reorganization matter. They were very conservative efforts, and I think that it will be a long time evolving something along that line. So we haven't added anything to the argument at this point ourselves so far as we're concerned. But whatever comes out of this, it would be helpful if someone could take the ball and develop a new standard which would appear reasonable to the world, and we could get back to using the business judgment rule, which I strongly believe is critical to the operation of a business corporation.

What is the current state of the law? In my own view, it is best illustrated by a colloquy that occurred several years ago in a New York panel of eminent corporate lawyers. The standard that was on the table at the time was the Arshat business judgment rule standard in the Hofstra Law Review¹⁵ in which directors were exonerated unless they failed one of a series of tests. And one of them was that the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation. The debate which followed was, "Is there a reasonable test, is there a rational test," and this kept coming up. During this debate, one office lawyer turned litigator, from outside of New York City, from time to time would lean forward and say "facts, facts." This went on, and finally a former SEC Commissioner proposed a perfect hypothetical of the perfect process and an absolutely terrible result and what would happen in that situation. Many of the corporate lawyers there concluded that the court would pass that because the process had been followed. Finally somebody turned to the litigator and said, "What is your view of this?" and he said, "Let me tell you about a case. We had one where we had the fairest process anybody could ever imagine but the court enjoined the board from taking a low prior bid." Somebody asked what was the basis for the court's decision. The litigator explained that the court did this by journal entry saying "opinion to follow," and of course it never did.

My own view of this from litigating and advising boards, from reviewing cases, is that the process and the result are part of an overall picture. And I don't care what the rule is, a good process influences the view of the result and vice versa; and it has an influence on the transaction itself if you can implement a good process.

The facts are what controls the decision, whatever the description of law is by the court, and I will just for a moment run through some of the important cases that have occurred recently. We would start with the *GM* [Grand Metropolitan] *Sub Corp. v. Liggett*¹⁶ case in 1980 in which the Liggett directors sold the subsidiary which was

15. Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

16. *GM Sub Corp. v. Liggett Group, Inc.*, 415 A.2d 473 (Del. 1980).

the primary interest of the bidder partly for the purpose of thwarting the takeover. They admitted this very candidly in their Williams Act filings. Obviously the lawyers had read *Santa Fe Industries, Inc. v. Green*¹⁷ and *Royal Industries*,¹⁸ and they made it very clear that one of the purposes was to thwart this transaction. It was a good price for the sale and in the actual litigation the bidder, Grand Metropolitan, refused to tell the court that they would pull the offer if the sale went forward—and the court asked that question directly to the lawyers on several occasions. Despite the public statements that had been made by Grand Metropolitan, they were unwilling to walk the plank and make that statement to the court in the case. The court permitted the transaction to go through and in fact Grand Metropolitan did not pull their offer and they continued to make an offer for the company. The facts in that case in my view controlled the court's view of what was going on.

In *Johnson v. Trueblood*,¹⁹ which was regarded by many as a strong extension of the business judgment rule, the court held that the fact that there may have been motives of self-interest did not prevent the application of the business judgment rule because there were other valid business purposes in that situation.²⁰ The facts in that case were that A held the majority of the shares, B held the minority. The corporation needed money. The minority shareholder offered a premium over what A was willing to bid for the new shares which were to be issued. If A had been willing to sell, B would have been able to buy control from A. A was unwilling to sell it to him and the court upheld that reasoning. It was a perfectly reasonable position for A to take, but on the surface of the court's opinion it does look like B had a very strong case.

The *Treadway*²¹ case was hailed by the *Wall Street Journal*²² as being a strong extension of the business judgment rule and perhaps overstepping the limits in that case. In that case the lower court set aside a transaction with a white knight because the lower court in effect found that the CEO of the target was a blackguard. That may well have been the case, and the courts stretched to deal with that issue. On appeal that was reversed. In effect the appeals court said this is just another dog fight. There are blackguards on both sides, and in effect that may have also been true. The court did not smack anybody's hands. They simply let the transaction go forward in a situation in which the bidder had already obtained thirty-three percent of the stock and had threatened to block any other alternatives, and the target was simply trying to sell a white knight an unblocking position to mold the deal. The Second Circuit noted that the outside board members were losing their seats. This was one of the factors that was noted in the case. But the key findings were that there was no conflict on the part of the board and that there was no evidence of dominance by the CEO, and these were in part dependent upon the findings of the courts below.²³ So, again, the facts did seem to support the decision that was made.

17. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

18. *Royal Indus. v. St. Regis Paper Co.*, 420 F.2d 449 (9th Cir. 1969).

19. 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

20. *Id.* at 292-93.

21. *Treadway Co., Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980).

22. *Wall St. J.*, Aug. 14, 1980, at 8, col. 3.

23. *Treadway Co., Inc. v. Care Corp.*, 638 F.2d 357, 384-85 (2d Cir. 1980).

In *Crouse-Hinds*,²⁴ I think partly because of the reaction to the *Treadway* case, the district court held that because the directors were not losing their seats in the white knight transaction involved in that deal, the burden of proof would shift. The panel on appeal included the decision writer in *Treadway*. The panel hastened to say that the fact that the directors may lose their seats is not an indication of disloyalty in and of itself. They examined the facts of the situation. It was a two percent above market bid, a low-ball offer. There was no record in that case to support dominance of the directors or any self-interest in fact on the part of the directors because it was tried hurriedly on affidavits. As a result, the court affirmed the judgment.

Now we can go on through all kinds of cases; time will not permit me to go on and discuss Judge Kinneary's opinion here²⁵ and the Second Circuit cases²⁶ which have refused to follow Judge Kinneary. Perhaps I'm just being cautious. But I would suggest to you that we have a situation today where by and large no matter how we have phrased or formulated this rule, the courts do look at the facts.

Now the facts include the hurriedness with which the case is tried. In the tender offer situation, in many instances, bidders are so anxious to keep moving (because they don't want people overbidding them) that they do not take the time to develop the kinds of situations which may in fact exist on that board.

Now we've had a lot of discussion here in the last two days of whether boards are disinterested or not disinterested and whether it's a good old boy network and so forth. I'm here to tell you that all of these things exist. Many managements are true blue, many are blackguards; many directors are true blue, some of them are blackguards. There's all kinds of mix involved in these things, and it's not just whether they've got their hands in their pockets. The money involved in staying on the board is not the issue generally. It is the sense of loyalty. It is the thing that Alan pointed out: that this management has been committed to operate this company, and there is some deference to that, because the way you keep management is to give them some deference.

All of these factors exist, and if the bidder will take time to develop all those and throw them in the crucible, then the court can in fact make a real evaluation of what the facts are in that case in terms of business loyalty. And if bidders don't choose to do that, that's tough luck, and I hope that the business judgment rule will continue to apply and the burden of proof will remain upon the movant.

I think that is a good rule to prove that issue even when it's the defensive board moving to dismiss a shareholder derivative action, and I think the burden should be on the moving party in any instance. And if we keep that in mind, and if we remember that it is partly a matter of the particular court you are in front of and how to communicate with that court and how to communicate with your board and your director, then you can structure something that will in fact work under the business judgment rule both in terms of defense of your company and also in terms of the national interest in the result.

24. *Crouse-Hinds Co. v. Internorth, Inc.*, 634 F.2d 690 (2d Cir. 1980).

25. *Mobil Corp. v. Marathon Oil Corp.*, No. C-2-81-1402 (S.D. Ohio Dec. 7, 1981); *rev'd on other grounds*, 669 F.2d 366 (6th Cir. 1981).

26. *See Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983).

Prof. Kozyris: Thank you, Jim.

Professor Buxbaum has been introduced already twice and he was our keynote speaker and also a commentator yesterday so I will only say that he's a Professor of Law at the University of California at Berkeley and also a co-author of a major book in the area of corporate law. I gave him the most difficult assignment of all for today. So many views have been expressed moving in so many directions that I thought he is one of the few who have the understanding and the talent to put it all together in one form or another in the concluding comments, so, Dick, take it from here.

Prof. Buxbaum: I am glad Professor Hamilton made the comment that at least a basic agreement was apparent on the panel. I was afraid we were going to be in the position of Sydney Smith, in the London of 1840, who, caught between two fishwives, as he described them, hurling bitter invective at each other from their respective balconies across a narrow street, observed to his friend that they would never agree for they were arguing from different premises. We're going to be somewhat in that boat here but I'm glad to see we have avoided that level of disagreement.

I think I see three areas that have emerged from this discussion and will identify them quickly after making two preliminary comments. The first is a warning that must constantly be made: Like people, corporations don't just come in size forty-six long and size thirty-four regular, but along a continuum. Many corporation statutes and many judicial rules are designed for the entire range of corporations. Even if we exclude the close corporation as a term of art for the very small, personally managed corporation, we still have a wide range of management: from shirt-sleeve management which is close to day-to-day operation; through informal though less frequently meeting operational management; to very formal large scale management with structured infrequent meetings that are characterized by structured information flows, structured committees, and so on. It is an extremely difficult job to capture that range in any single discussion. We have been hearing mainly about the larger, upper end of that range, but any discussion of appropriate rules is going to have consequences throughout the range. That's the first preliminary point.

The second preliminary point I take from this discussion is that at least in this area, the law needs to stay as much as possible with objective rather than subjective standards of conduct. I can't speak for criminal law, but in business law it seems to me we are adherents of that branch of theology which says that by their works shall ye know them. It is very difficult for us to formulate rules if we begin to forget that basic premise. That has quite instrumental consequences to the definition as well as to the operation of any of these sets of slippery doctrines, such as the business judgment rule.

With those two preliminary comments aside, let me see if from the very provocative presentation by Dean Manning and from the very lively contributions of the panelists we can now provide some themes for audience discussion. On the question of the duty of care, I found very provocative Dean Manning's point that omission is going to be as big a problem as commission. How can the law face that?²⁷ First, even

27. See Buxbaum, *Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CAL. L. REV. 1122 (1980).

in the area of omission it seems to me that we have many basic types of omission. I'll suggest a typical extreme or two. One is the omission to make structured inquiry of a type that is known to be available, whether from outside professional sources or otherwise. A management that simply goes on blithely making off-the-cuff decisions may need to be brought up short under an appropriate standard of due care. I believe Dean Manning's point is that it is possible to close out that type of omission and I agree.

The other omission is a little trickier, namely, the omission of the company which goes on making horseshoe nails while the world changes, which doesn't take risks or make the necessary adaptations to change. The *Penn Central* example was used a couple of times and I think it is indeed a good one. Now there I do think, indeed, that the law faces an extremely difficult task. One approach, however, is already known—it is found in the old case decided by Learned Hand, *Barnes v. Andrews*,²⁸ which introduced a loss causation concept to this area, and which is still valid as a limiting case. That is to say, you have got to show some fairly specific relationship between that which was left undone and ought to have been done and the eventual harm. I think it is appropriate that in that area at least the rules are not too ready to fasten liability. Beyond that there isn't much more to say about it. I think we may see more development of this concept if we get more bankruptcies caused by this kind of nonmanagement. I'd be interested to hear Bayless Manning's views on that.

When we turn to the second question, however, of the relation of positive risk-taking to the duty of care, I'm sure we would all agree that companies exist to make a profit; that entrepreneurial decisionmaking goes on even within the biggest corporations and not just within small ones; and that we don't second guess rationally structured risk-taking decisions. That doesn't mean that one can't have bounded procedures within which risks are taken, the violation of which can be actionable. The two are not inconsistent. I'll suggest a trivial, though controversial, example. A company that decides to undertake a major and risky new venture, with substantial downside liability well beyond the amount of the capital committed to the new venture, would be imprudent if it did not separately incorporate that risk-taking new venture and structure it on that basis. I wouldn't have any problems seeing a court that is using some version of a business judgment rule in this area second guess the error of this approach. You might have arguments about the legitimacy of limited liability of corporations; but that's a different question. If the law is firm that even corporations have the right to limit their total risk through separate subsidiaries, then obviously we also learn something about operational behavior from such a principle.

The second substantive point concerns the takeover area. I will be very brief, mainly because the themes that have been raised probably are going to be followed up later by Ed Greene. The one point I will bring out here is the fascination of this panel and of the bar with this new notion of the shareholders' advisory vote. Don Schwartz brought it up in his paper when he pointed out the difference between a takeover and the statutory merger procedure. In the latter the board has a gatekeeper function, and

28. 298 F. 614 (S.D.N.Y. 1924).

may block transmission of a proposed merger to the shareholders by its decision that it is not in the best interest of the corporation. Obviously there is an effort underway to transfer that basic state statutory approach into the takeover bid area. My problem with it is this: Assuming you could manage an advisory vote (forgetting, in other words, the speed of bids and whether it is legitimate in terms of market efficiency to delay bids), what do you do with that advisory vote? What does that vote, whether it goes one way or the other, do to the board of the target company? What does it do to the very structure of the Williams Act? I think a host of unresolved problems is raised by that approach.

That ties to the third point, which is the conflict of interests point. I think it is clear that you cannot legislate the ideal director, even if Dean Manning has identified him as also being the typical one. What you want are persons of intelligence and of character. It is hard to put in a statute that if you are not a person of intelligence and of character you are not permitted to have available the business judgment rule and the deference it otherwise provides. Here is where my point about being known by your works must come in. We can only take care of the most easily identifiable versions of interested versus disinterested directors. It is hard enough to create consanguinity rules to the third and fourth degrees, and they are trivial. I admire those who try them, as the ALI Project is doing to some degree, but they are not the issue. Therefore, to confirm what was really Professor Schwartz' point, too, we cannot avoid the need for review of action since we cannot rely upon simple definitions of interested or disinterested. That's so clear to me that I would argue that it can be taken for granted.

With that, we come back to what I still submit is the major theme here, and that is who judges the judges, or who is the judge. The problem with the Ms. Jones version of Dean Manning's typology is not that I do or do not agree with his world view, but rather that I don't agree with the unstated consequence that Ms. Jones is her own judge. That's the issue. That leads us, of course, to the question of the way in which these matters come up. In litigation, at least in derivative litigation, the new game in town, of course, is the role of the independent litigation committee and of independent review. Now, I think we are forgetting one aspect of that, one that is the easier matter, and that is that in the relatively straightforward conflict of interests situations we have statutes that should be considered.

These statutes provide that unless an appropriate number of informed, disinterested directors in fact have approved a particular transaction, the matter can only be approved if it is demonstrated to be fair. The problem is that the challenged transactions should be "demonstrated to be fair" not by Ms. Jones to Ms. Jones' own satisfaction, but rather to someone else. That someone else is the court. The problem with the independent director termination approach is the inherent collision with that statutory conflict of interests rule. I've tried to sketch it out briefly elsewhere.²⁹ I know there are ways of arguing about this issue, and that the decision not to litigate need not be treated as an approval of the underlying transaction. Nevertheless, in a

29. Buxbaum, *supra* note 27.

larger sense, not in the technical sense, there is something about who judges the judges that continues to give us trouble on that aspect; and this has surfaced several times here. On this aspect of the independent review structure, it is, therefore, no wonder that we are going to continue to find courts—even those you might have assumed would not go that way, such as in *Joy v. North*³⁰—being extremely loath to remove themselves from that inherent need for a second judgment of the committee judges. I don't see how a judiciary can be expected to abdicate in that field, and I think the Delaware struggle with *Maldonado*³¹ and the Second Circuit's *Joy v. North* are perfect illustrations of that fact.

I'll close with what I have found to be a rather nice test of these propositions. Let's look for lawyer-like instrumental rules when we've got one of these independent review problems. How would you feel about the suggestion that the lawyers who are to be appointed to advise the independent committee in its review of the transaction themselves may only be appointed from a list which has been consented to by the plaintiff. It's a sneaky little sort of idea and I think it brings home very quickly the issue of who judges the judges. I would be willing to try an experiment in which one accepts the results of that committee review (assuming, of course, that the committee goes along with the lawyers) provided that the plaintiff had a shot at appointing the lawyers or at least if the judge appointed the lawyers in consultation with, and indeed, as in an arbitration process, only with the consent of the two sides to that dispute. I think we'd be surprised how that little instrumental rule would bring us back to our different premises.

Prof. Kozyris: Questions and also brief comments, very brief comments, in view of the time, are in order, so before the panel has a chance to return and exchange their own views, are there any comments, observations, challenges?

Questioner: I was pleased to see that in discussing the business judgment rule several of the panelists referred to tort law. Dean Manning, for example, made an analogy to an automobile driver, but I think the better analogy would be to professionals, doctors, lawyers, and so forth. I think it is better to say that the law has been more rigorous in determining what constitutes negligence or malpractice of a doctor or a lawyer than it has with respect to what constitutes malpractice, negligence, breach of the duty of care, or failure to meet the standards of the business judgment rule of a director. I was just wondering what the commentators would think, particularly Dean Manning and Professor Schwarz, who take rather opposing views, how they would feel about the law changing direction and applying the same kind of rigor to the malpractice of business as applies to doctors and lawyers.

Dean Manning: I keep groping for a way to articulate in a way that communicates (which I have obviously again failed to do) what I think is a fundamental intellectual problem. It is not a policy problem I am advancing for the moment. We can debate policy later. The fundamental intellectual problem has to do with doctrinal transfer. The law has not attempted to construct specially designed doctrine for the

30. 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).

31. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

business reality of the board room. Instead it has consistently tried to transport into, and graft onto, the world of the corporate director concepts that are essentially tort concepts. As an intellectual matter, those grafts do not work. The fundamental reason these concepts work in other areas—let us take the example of the surgeon, just mentioned—is that we have a general common way of assessing, describing the accepted notion of what the surgeon is supposed to do, and *how* he is supposed to act in a particular instance. We also have tools—such as testimony of other surgeons and literature—to tell us what they're supposed to do. But in the case of corporate directors, both of these elements are missing. We have no accepted notions of what directors do as a flow of process, or what they should do in a particular instance. Our current law says, in substance, "we do not know what directors are supposed to do—but by George, they are supposed to do it carefully!" But one *cannot* assess whether something was well done, or poorly done, or done as well as can be expected, unless he has some concept of *what* was supposed to be done.

The director's job is a day-in, day-out, year-after-year assignment. It is a *flow* of countless decisions, nondecisions, actions, inactions, decisions not to take action, perceptions, semiperceptions, questions, nonquestions, judgments and nonjudgments, omissions, initiatives, etc. The real responsibility of a director as I see it—the only one that is conceivably doable is for the director to handle that flow of process in a reasonable manner. The object of the verb "do" in the case of the director must be the ongoing performance of his collective flow of duties. Thus, a director who ignores his assignment, or seldom if ever does his homework is delinquent in the performance of his real duties and subject to liability for consequent damage. But a totally different question of legal standard setting is required to decide whether an earnest, hard-working, diligent director should be held liable with regard to discrete corporate transactions retrospectively selected by a plaintiff out of a hundred thousand directorial actions and inactions.

Prof. Schwarz: I'm sure I don't belong on this panel or probably anywhere else. I've never paid any attention to the duty of care aspect of the business judgment rule, because I don't think it properly belonged there and I accept the premise of your question. I don't think the problem is any different than it is in torts, and I don't know anything about torts. Therefore, I don't know anything about the duty of care, but I assume torts people who think about things like this could do a lot in this area. I mean I think if a meticulous surgeon is a foot surgeon he would be negligent doing thoracic surgery and if a conductor is appointed to the board for some kind of adornment purpose the person who tells us the foot surgeon would be negligent in doing thoracic surgery would probably also tell us that the conductor is being negligent in doing anything but being adornful, and I think different directors are chosen for different purposes on public boards. I think the tort lawyers wouldn't predict the outcome of a given case but could give us parameters of judgment of whether a person understanding why he was chosen, understanding that the shareholders were told either explicitly or implicitly why the person was chosen created a set of expectations of what he would do and how he would do it and tort principles would indicate to juries in their infinite wisdom whether it was done reasonably or not. I basically accept the premises.

Prof. Kozyris: Brief comment by Dick.

Prof. Buxbaum: If I am a principal and appoint an agent, and the agent does not carry out my duties properly, is that a tort to me or is that a breach of my contract with the agent?

Prof. Kozyris: Good question. Morgan?

*Prof. Shipman:*³² Yes, I would like to follow up with a question to Dick. I think the answer is in tort law and I think we've overlooked it. The question is really one of immunity or privilege. The business judgment rule is really an immunity or privilege rule saying that there are certain things, *i.e.*, judgments, that are unlike whether to operate two inches deep or three inches deep, whether to file at the state capital or the county courthouse in northern Ohio, whether the reply is due in ten days or eight days and the courts are wise enough to realize that they don't have the wisdom and they are making the implicit analogy to the political process. Do we sue the President of the United States in the U.S. District Court because he decides to send troops to "x" or not to send troops to "x"? Do we do the same thing to the Governor of California or the Governor of Ohio, to a representative in Congress because she applied the wrong judgment in voting? The answer is that in a lot of processes we immunize, and the business judgment rule is an immunity. That would be the place where I would start with my criticism, although it will be rather moderate, of the ALI and ABA projects. I don't think they really recognize that the business judgment rule is a rule of immunity or privilege. I think once we recognize that the real analogy is with the political process on some of these judgment questions, rather than whether the surgeon operates too deeply, we will be way ahead.

Prof. Kozyris: Thank you, Morgan. Harvey, a brief comment on this.

Prof. Goldschmid: Analogies often work, but sometimes they cloud our thinking. The key question to ask yourself here is: What are we trying to do in the corporate context and why are we trying to do it? It seems to me clear, and the ALI drafts state it this way, that the business judgment rule is meant to be a safe harbor. What can you ask from a director? You can ask a director, whether it's Zubin Mehta or anyone else (*i.e.*, a generalist with the capacity to do the job) to prepare himself or herself—to do "homework" and to understand the contours of a decision. The ALI drafts require this and, contrary to Bay's view, if a director has not done it, he may be found liable, assuming there is causation. We can ask a director to operate in a large, discretionary ballpark in terms of "rational basis." Why don't we ask more? Why don't we go with Professor Sorensen and just say if he's "unreasonable" that's enough? We have got to think of context here. We are talking about economic institutions and decisions some of which we know will be unsuccessful. It's only the unsuccessful ones that will be challenged. What will we inhibit if we provide for easy liability? Well, think of General Electric or RCA going into a new generation of computers. General Electric wrote off something like \$250 million as a result of going in. RCA wrote off something like \$750 million. To open directors up to a legal rule that says "if you're unreasonable, you're liable" will inhibit risk taking. We

32. Morgan Shipman, Professor of Law, Ohio State University.

want directors to be venturesome and to take rational business risks, because when IBM invested in a new generation of computers it did extremely well and we all gained from its investment. There is good reason to try to limit litigation and judicial intrusiveness with respect to private sector decisionmaking. The reporters for the ALI are being protective, and we mean to be. Assuming homework and assuming—and this is critically important—that there's no conflict of interest, protection should be afforded. It seems to me healthy to think in context, think of what we're trying to get various actors to do, when we think about how we're using business judgment.

Prof. Kozyris: Thank you, Harvey. Any other comments?

Questioner: First, I have a comment and then a couple of questions. The comment is basically to Professor Buxbaum, perhaps the other side of the coin to the suggestion that special litigation committee attorneys be approved by plaintiff's attorney. The other side of the coin I think perhaps is brought forward by the decision *In re Fine Paper Antitrust Litigation*.³³ The opposite side of the coin is the approval of nonselective, involuntary plaintiff's derivative counsel by the corporation. The two questions I have are the following. The first is the Zubin Mehta standard of care and something that Professor Goldschmid just referred to, the situation where he truly cannot understand the decision. We have a lot of the Zubin Mehta major type of directors out there. Maybe some of them were sitting on the Board of General Public Utilities before Three Mile Island. Can he ever understand, can he ever make that reasonable judgment that Harold pointed to; and if not, what standard of care should be applied to Zubin Mehta in that situation? The second question I think also comes down to the issue which Dean Manning referred to in his presentation, the technical problem of how far down the decisional line the business judgment rule is to apply. It is easy to say that it covers policy, not ministerial decisions. It's easy to say let's build a plant, let's acquire a company; but what about the manager who hires one person for a particular position as opposed to another? The guy who tries to save cost by cutting back his environmental staff maybe misses a problem that has developed. Are those decisions not policy decisions, and unlike decisions at the board level are they not protected? I am intrigued in this respect by Professor Frankel's suggestion that in fact those decisions which are always more reflexive probably should leave you more protection than the grand policy decisions.

Prof. Goldschmid: I'll take Zubin Mehta. If he's got a weak head, if he just doesn't have the general capacity to do his corporate job, then I think we should tell him not to take a directorship. We do know, however, that there are many decisions that will be extremely complex even for the reasonably intelligent director who has the capacity to do the job. That's where doctrines like reliance fit in. A director can reasonably rely on experts. Informing yourself may be complicated in the corporate context, but the new ALI draft asks only that a director or officer be informed with respect to the subject of the business judgment to the extent he reasonably believed to be appropriate under the circumstances.³⁴ Insofar as we're talking *Fine Paper*, it

33. 617 F.2d 22 (3d Cir. 1980).

34. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, §§ 4.01(b), 4.01(d)(1) and comment.

seems to me the trick is not to get rid of the derivative suit by easy termination, but if there's a problem, to look at computation of attorneys' fees in derivative actions and to correct other specific abuses. Indeed, these issues are dealt with in Part VII of the ALI's Corporate Governance Project.³⁵

Dean Manning: With respect to that question, I have always assumed that the business judgment rule is applicable at the highest corporate level only. The factory manager who fails to carry out established corporate programs gets fired. Decisions by people who have the ultimate responsibility are subject to the business judgment rule.

Questioner: Would you say in that situation you don't sue the plant manager or do you sue the plant manager?

Prof. Sorensen: I did not wish to answer your Three Mile Island question but rather to note that it is precisely the question we ought to be addressing. Tort law standards of care are often no more than procedural. They don't instruct what ought to be done in given situations. Legal malpractice standards, for example, do not establish when to settle, or whether to make this argument or that. When you're dealing with safety precautions for Three Mile Island or with establishing a branch of McDonald's, the difference ought to be in the decisionmaking procedures required for the director to meet his or her standard of care. I don't see that that presents insuperable difficulties. The fact that there is a wide spectrum of acceptable decisions ought not to make the actual decisions immune in every instance.

Mr. Tobin: Getting back to the original question on the analogy to malpractice, I have always thought that both tort law and contract or agency law have built into them Morgan's concept of immunity for issues of judgment in the absence of undertakings under tort law to have perfect judgment or in the absence of something in your contract that specifically undertakes to be *el supremo*. Every field of review that I'm aware of has that standard in it, and it seems to me that it applies to managers as a matter of agency law; it applies to directors as a function of decisional law with respect to the law of corporations, whatever you want to call it. I think it's there. The real question is what is judgment and what is prudence and care. I'm reminded of a speaker in a panel some twenty years ago on real estate title examination in which the speaker was carefully delineating the difference between errors of judgment in title review and errors resulting from negligence. One was immune and the other wasn't. His advice was to keep your malpractice policy up and to confess being a little careless once in a while rather than being stupid.

Prof. Kozyris: Any other questions from the floor or observations?

Questioner: Dean Manning, your economist comes again. Yesterday was the tenth anniversary of the Saturday Night Massacre. We did not allow the President to be sued but we did seek his removal. Now, it may well be that in the instance of lack of due care we might at least seek the severance of a lot of directors and in effect, get the judges to provide some element in getting us new directors. There's no reason they should be allowed to keep their position on the boards and we ought to have

35. *Id.* at 217-426.

better ways than takeovers to change the directorial and managerial position of corporations.

Prof. Kozyris: Some process of impeachment of directors?

Dean Manning: Perhaps. It's an interesting idea.

Prof. Kozyris: Professor Frankel wanted to make a brief observation.

Prof. Frankel: I want to make one observation with respect to the comparison to driving a car, which is active, and not making any decisions which is kind of passive. The test is not whether the action is active or passive. When I put myself in the driver's seat, that's when I become liable and if I stop in the freeway, where the rule is I shouldn't stop and somebody hits me from the back, I am liable even though I didn't drive, I didn't do anything. It's putting yourself in the driver's seat that is the test, and the same applies to a director. If he is in the driver's seat and he drives a corporation that's when liability begins. Now it is true that perhaps passive activities should trigger some other liability or the rules regulating passivity should be different, but the principle is the same.

Prof. Kozyris: Thank you, Professor Frankel. A final question or observation? Stu?

*Mr. Summit:*³⁶ Almost everyone has to drive and there is no problem getting people behind the wheel to get where they are going. The trick is to prevent them from killing somebody on the way. We do have an enormous problem finding good, responsible people to devote themselves to run a business for the principal benefit of others, the shareholders. How to structure our rules of law in order for the best people to serve in the best way on these boards is an issue that must be seriously addressed.

36. Stuart Summit, Partner; Burns, Summit, Rovins & Feldesman, New York, New York.

