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Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule

Stuart R. Cohn*

I. Introduction

Duty of care litigation against corporate directors generates an abundance of commentary despite a scarcity of successful results.¹ Cases that assess damages against negligent management are rare to the point of becoming an endangered species.² The recent introduction of litigation committees to review derivative actions³ is only the latest

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1. Research reveals only seven successful shareholder cases not dominated by elements of fraud or self-dealing. See cases cited *infra* note 2; see also *Kaplan v. Centex Corp.*, 284 A.2d 119 (Del. Ch. 1971).

2. "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). Professor Bishop found only the following four cases: *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397, 107 N.Y.S.2d 1004 (1953); *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966); *Clayton v. Farish*, 191 Misc. 136, 73 N.Y.S.2d 727 (Sup. Ct. 1947); *Selheimer v. Manganese Corp. of Am.*, 423 Pa. 563, 224 A.2d 634 (1966). See Bishop, *supra*, at 1099-1100. Professor Bishop opined, and this author agrees, that "none of these cases carries real conviction." *Id.* at 1100. The American Law Institute draft report on corporate governance recently added two cases to this list. See *DePinto v. Provident Sec. Life Ins. Co.*, 374 F.2d 37 (9th Cir. 1967); cf. *Heit v. Bixby*, 276 F. Supp. 217 (E.D. Mo. 1967) (some negligent directors and some self-dealing directors). PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01, at 138 (Tent. Draft No. 1, 1982) [hereinafter cited as CORPORATE GOVERNANCE].

3. Because a derivative action asserts a corporate right, the decision whether to pursue such action theoretically belongs to the directors. Therefore, a shareholder in a derivative action must prove that the board, upon demand, has unjustifiably refused to seek redress for the alleged

defensive procedural gambit in the emotional arena of shareholder litigation. Plaintiffs' counsel have proven their ability to cope with other procedural pitfalls of standing, security for expenses, demand on directors, and burden of proof.⁴ Litigation committees pose yet another impediment, although enough of the wolf is showing through the sheep's clothing to suggest that courts are beginning to view this defensive device with skepticism.⁵ Such procedural hurdles are more likely to detour than to arrest the underlying litigation.

Of far greater import in such litigation, whether derivative or direct,⁶ is the standard of conduct upon which the merits of a due care action are judged. Here, the principal detriment to shareholder litigation

wrong. See 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 717 (1959). The demand requirement is excused if it is "futile" (e.g., the board is composed of or dominated by individuals who are the alleged wrongdoers). *Id.*; see, e.g., *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49, 53 (5th Cir. 1980) (demand excused when controlling shareholders were involved in allegedly improper conduct), *cert. denied*, 450 U.S. 1029 (1981).

In an effort to reassert a board role where all or a majority of the board are named defendants, boards form ad hoc litigation subcommittees, which are composed solely of nondefendant directors (who may have been appointed to the board after litigation was commenced and especially for such purpose), to determine the corporation's response to the derivative action. See Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 620 (1982); Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1907 (1983). Not surprisingly, these committees usually decide to seek a dismissal on grounds of lack of merit or a balancing of corporate interests. See *id.* at 1905. The rising popularity of such committees has spawned a distinct area of litigation regarding the appropriate judicial standard for the review of committee determinations. Compare *Auerbach v. Bennett*, 47 N.Y.2d 619, 623-24, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 921 (1979) (the litigation committee's business judgment to seek dismissal of the derivative action is beyond judicial review except for questions of independence and procedure), with *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981) (even if independence and reasonable procedures are proved, the court should apply its own business judgment).

4. For discussions of the procedural perils of the derivative suit and plaintiffs' counsel's efforts to overcome them, see generally Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Dykstra, *Revival of the Derivative Suit*, 116 U. PA. L. REV. 74 (1967); Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944).

5. The reality is, therefore, that special litigation committees created to evaluate the merits of certain litigation are appointed by the defendants to that litigation. It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee.

Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983). The potential for structural bias led the Iowa Supreme Court to adopt what it regarded as a "prophylactic rule" proscribing litigation committees appointed by defendant directors in a derivative action. *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983).

6. Shareholder litigation based on an alleged violation of the duty of care may arise from an injury either to the corporation or to individual shareholders; both claims may be joined in a single action. For example, in an action against defensive measures taken by the management of a takeover target, there may be claims both for injury to the corporation from the adverse consequences of the defensive measure and for injury to the shareholders who no longer have the opportunity to tender their shares at a premium price. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). The derivative action has procedural elements not found in direct actions, but both have the same burdens of proof and legal standards.

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tion is the nearly universal judicial reluctance to apply diligence standards against well-intentioned, non-self-enriching directors and officers.⁷ Courts often commence their opinions with the stern but

In much of this litigation, particularly in derivative suits, plaintiff's counsel is the principal party in interest because attorney's fees often will exceed the shareholders' pro rata recovery.

7. The duty of care provisions of the Model Business Corporations Act provide:

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

- (a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,
- (b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or
- (c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence,

but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

MODEL BUSINESS CORP. ACT § 35 (1979).

Twenty-two states have adopted statutory provisions substantially similar to the Model Act, or otherwise have provided a general standard of care based on prudent or reasonable conduct. See CAL. CORP. CODE § 309(a) (West 1977); CONN. GEN. STAT. § 33-313(d) (West Supp. 1983); FLA. STAT. § 607.000(4) (1977); GA. CODE ANN. § 22-713 (1977); HAWAII REV. STAT. § 416-91.5(c) (Supp. 1982); IDAHO CODE § 30-1-35 (1980); IND. CODE ANN. § 23-1-2-11(2) (Burns Supp. 1978); IOWA CODE § 496 A.34 (1977); LA. REV. STAT. ANN. § 12:91 (West 1979); ME. REV. STAT. ANN. tit. 13-A, § 716 (1964); MD. CORPS. & ASS'NS CODE ANN. § 2-405.1(a)(3) (Supp. 1983); MASS. ANN. LAWS ch. 156B, § 65 (Michie/Law. Co-op. 1970); MICH. COMP. LAWS ANN. § 450.1541(1) (West 1973); MINN. STAT. § 301.31 (1982); N.J. STAT. ANN. § 14A:6-14 (West 1969); N.Y. BUS. CORP. LAW § 717 (Consol. Supp. 1979); N.C. GEN. STAT. § 55-35 (1982); OKLA. STAT. tit. 18, § 1.34 (1981); PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1983); R.I. GEN. LAWS § 7-1.1-43 (1969); S.C. CODE ANN. § 33-13-150 (Law. Co-op. Supp. 1982); TENN. CODE ANN. § 48-813 (1979).

The common law recognized a duty of care well before states began to embody it in their statutes. One of the earliest reported cases on this point, *Charitable Corp. v. Sutton*, [1742] 2 Atk. 400, 26 Eng. Rep. 642 (Ch.), contains a remarkably modern formulation: "By accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence. . . ." Moreover, the common-law formulation is generally uniform among the states. See, e.g., *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex. Civ. App.—San Antonio 1966, writ *ref'd n.r.e.*) ("All courts seem to agree that a director owes a duty to the corporation to exercise due care in the management of the corporation's affairs."). In some states, the due care standard is reflected obliquely in the statutory indemnification provisions. See, e.g., TENN. CODE ANN. § 48-408 (1979) (permitting indemnification of a director for liability and expenses "if he acted in good faith in a manner that he reasonably believed to be in or not opposed to the best interests of the corporation"). The proposed 1983 Revised Model Business Corporation Act adds a specific reference to business judgment to the current provisions regarding good faith and care. The new provision indicates that a director discharges his duty "when exercising his business judgment, with the belief, premised on a rational basis, that his decision is in the best interests of the corporation." REVISED MODEL BUSINESS CORP. ACT § 8.30(a)(3) (Exposure Draft March 1983). The proposal mixes subjective and objective elements and suffers from problems of redundancy similar to those found in the ALI Tentative Draft discussed *infra* in text accompanying notes 177-81.

tired maxims of fiduciary duties, or the common-law and statutory norms of diligence and care, only to subsequently invoke the purifying balm of the "business judgment rule," a judicially developed doctrine that has come to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality.⁸ Although the doctrine began as an adjunct to duty of care standards designed to protect directors' decisions against hindsight evaluation when appropriate diligence had been exercised, the doctrine has enveloped the primary inquiry. This approach shifts judicial emphasis from questions of diligence to narrow, motive-oriented factors that must be satisfied in order to overcome the business judgment rule's presumption of regularity.⁹

Judicial retreat into the presumptive arena of the business judgment rule creates considerable doubt that there remains a viable shareholder action in areas other than fraud, conflict of interest, disloyalty, or the disclosure concerns of the securities laws. So common is the disposition of cases by reference to the business judgment rule that a casual observer could readily conclude that the obligation of care and the defensive presumption of the business judgment rule are mirror images of a unitary standard.¹⁰ It is doubtful whether there still exists a sanction for lack of care, unadulterated by self-enrichment or other opprobrious behavior. If the reasonable care standard is no longer a

8. Because they are given this wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the head of honest mistakes, and that is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs. This rule is commonly referred to as the "business judgment rule"

3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (rev. perm. ed. 1975).

9. Courts frequently invoke the due care standard and then proceed to the business judgment rule with only a cursory due care analysis. For example, in *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706 (N.D. Ill. 1969), Goodrich directors approved a \$35,000,000 acquisition in exchange for 700,000 shares of Goodrich stock to defend against a hostile takeover. The decision was made within the "first hour of the directors' luncheon meeting." *Id.* at 709. The directors received only a "hastily prepared two page memorandum and a one page statistical analysis." *Id.* The court noted that the directors were expected to exercise "that care which businessmen of ordinary prudence use in managing their own affairs." *Id.* at 711. Instead of analyzing whether the directors acted prudently, however, the court switched to the business judgment rule and insisted that plaintiffs prove "fraud or manifestly oppressive conduct" before it would set aside the directors' conduct. *Id.* at 712.

10. For example, the Securities & Exchange Commission (SEC) Advisory Committee on Tender Offers recently issued a report that addressed the role of state law in takeover disputes; it concluded that "essentially the business judgment rule should continue to govern most such activity." *Excerpts from Final Report of SEC Advisory Committee on Tender Offers*, 15 SEC. REG. & L. REP. (BNA), at 1376 (1983). The SEC has criticized the Advisory Committee's position for not giving sufficient weight to the interests of shareholders. 16 SEC. REG. & L. REP. (BNA), at 495-96 (1984).

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viable means for corporate governance, it should be removed from the common law and the statute books as a misleading shibboleth. If the standard is economically or pragmatically viable and relevant to shareholder interests, however, its preservation must be more forcefully advocated.

This Article proceeds on the premise that if shareholder actions for negligent mismanagement are to be an instrument of corporate control, the present ineffectiveness of such suits can be altered only by a two-fold response—a clearer delineation of minimal standards of director conduct and a more realistic set of sanctions in the event of deviation from those standards. Under such circumstances, the business judgment rule would resume its historical basis as a protection against hindsight evaluation of erroneous decisions, but would shed its protective role as a shield for all director action in the absence of fraud or other illicit behavior. In this light, Part II considers the arguments supporting the current judicial application of the business judgment rule. It is suggested that these arguments neither justify the current application of the rule nor adequately explain the paucity of successful shareholder litigation. Rather, judicial concern about the ambiguity of due care standards and the severity of available sanctions provides a more plausible explanation of judicial behavior. The now forgotten historic distinction between the business judgment rule and standards of director care is discussed, and recent judicial conflation of the distinction is explored.

Part III proposes a standard of reasonable care that, if adopted, would enhance shareholder litigation as an effective tool in corporate governance. Initially, the discussion addresses problems of definition that any standard of director diligence must face. Principally addressed is the role of directors in the modern corporate world. The Article proposes a standard of reasonable care that has two requirements: (1) directors should be alert to problems of major corporate concern; and (2) directors must engage in deliberative decisionmaking with regard to those concerns.

Because judicial reluctance to apply a standard of reasonable care to director behavior is due in part to the severity of available sanctions, Part IV proposes remedies that serve as realistic alternatives to the all-or-nothing approach of current compensatory remedies in actions at law. Equitable remedies of injunctive relief and compensation for corporate waste, if imposed, would alleviate judicial concern over the imposition of catastrophic liability.

II. The Need for Reformulation of the Standard of Reasonable Care

A. *Shareholder Litigation as a Necessary Element of Corporate Governance*

Numerous factors other than the threat of shareholder litigation based upon due care standards influence the conduct of directors. Motivations for careful director conduct include the pressures of achievement, status, and reward. Derivative actions seeking recovery for self-dealing, conflict of interest, fraud, or illegality and actions under the federal securities laws are well recognized and pose few of the problems of judicial relief that are encountered in the reasonable care area. In addition, market forces create incentives for maximizing corporate welfare. Courts may be deferring sub silentio to one or more of these factors in their frequent rejection of negligence allegations. Yet, upon close analysis, these arguments do not justify continued use of the business judgment rule.

Corporate antagonism to shareholder litigation in general has been based on the argument that such litigation reduces the ability of American businesses to compete with foreign business concerns by forcing directors to document their every move, thereby draining their resources and promoting director timidity.¹¹ But the legal requirement of reasonable diligence as evidenced by deliberative decisionmaking does not force the documentation or strait-jacketing of all aspects of corporate management. Most decisions that constitute the heart of industrial concerns, such as production, wage negotiations, pricing policies, and research allocations are appropriately assigned to managers rather than directors.¹² These decisions generally do not raise serious procedural concerns and do not invoke judicial scrutiny. It is the extraordinary action—the response to a potential shift in management control, the disposition of significant assets, the spin-off or acquisition

11. [W]e sharply dissent from the premise that encouraging more derivative actions alleging duty of care violations would be either wise or effective in promoting diligent behavior. Directors have a variety of incentives to do their job well; the fear of shareholder litigation is far down on this list of incentives—and should remain so. The last thing American business needs as it competes with its foreign counterparts is to be led by liability-shy directors whose major concern is to avoid risk, create “paper trails” and generally “cover” themselves.

STATEMENT OF THE BUSINESS ROUNDTABLE, STATEMENT ON THE AMERICAN LAW INSTITUTE'S PROPOSED “PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS” 53 (1983) [hereinafter cited as STATEMENT OF THE BUSINESS ROUNDTABLE].

12. See Wommack, *The Board's Most Important Function*, HARV. BUS. REV., Sept.-Oct. 1979, at 48, 48-49; cf. Brudney, *supra* note 3, at 607-09 (the board's function is to review the fairness of management self-dealing).

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of principal subsidiaries—raising long-term questions of control and corporate direction, often with substantial personal and financial stakes, that best justifies the distinction between management and board roles. The infrequency of such events in the life of a corporation suggests that the foregoing argument against shareholder litigation exaggerates the extent to which management is inhibited or directors are burdened.

Opponents of reform generally do not dismiss the standard of due care.¹³ Indeed, the movement in recent years to an increasing number of outside directors on boards is usually justified by the objectivity and skills that eminent outsiders, often chief executive officers, bring to the board process. Instead, proponents of the status quo emphasize the adequacy of market and regulatory controls to assure diligence.¹⁴ Undoubtedly, such controls are often effective, but reliance on market or regulatory controls may be misplaced when such controls are not self-executing¹⁵ or are subject to being neutralized by other forms of corporate action.¹⁶

13. *But cf.* Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 937 (1983) (noting that "very little of any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit"). Professor Scott's reliance on reputation and market factors to provide adequate incentives for diligence overlooks the pressures of collegiality in the boardroom, *see infra* notes 95-96, overemphasizes stock values as an element of insider compensation, and omits analysis of defensive measures that insulate incumbent management, *see infra* notes 35-37 and accompanying text.

14. *See, e.g.*, Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1288 (1982) ("The discipline exerted by product and capital markets, the market for managerial services, and the market for corporate control severely limits the divergence of interest between managers and investors.").

15. For example, the self-executing regulations of tender offers in the Williams Act, 15 U.S.C. §§ 78m(d)-(f), 78n(d)-(f) (1982), do not apply when defensive measures quickly succeed in preventing a threatened tender offer. *See Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1318 (W.D. Mich. 1978).

16. To deter unfriendly takeovers, many companies recently have adopted "porcupine" measures, which range from supermajority voting requirements to "poison pill" classes of stock. These defensive measures illustrate the need for more effective standards. For example, in its recent takeover struggle, Brunswick Corporation arranged to sell its "crown jewel" subsidiary to a third party in an effort to defeat a hostile takeover by Whittaker Corporation. *See Brunswick to Sell Its Medical Unit for \$425 Million*, Wall St. J., Feb. 12, 1982, at 6, col. 1. The effort was successful, but Brunswick's net worth, its prospects for growth, dividends, and working capital were diminished. *See Brunswick Expects \$218.2 Million Gain on Sale of Division*, Wall St. J., Feb. 18, 1982, at 12, col. 2 (noting that the divestiture may force Brunswick to reduce dividends and other expenses). When the Brunswick dispute was litigated, the court failed to examine whether any business-related facts supported the directors' decision to sell the subsidiary. *See Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill. 1982). The directors' prudence was questioned because the defensive measures began immediately after the Whittaker offer was announced and because the board received advice from investment bankers that "it was not possible for them to [value] the proposed disposition of Sherwood." *Id.* at 940-41. The court was impressed with the independence of the board; nine of the eleven directors were characterized as independent. *Id.* at 937. The court did not undertake a due care analysis, however, but found without explanation that the business judgment rule shielded the directors. *Id.* at 951.

The paucity of successful shareholder litigation may reflect judicial rejection of legal standards, or it may be the happy result of management's complete compliance with its duties. The latter assumption presumably may be credited to the deterrent effect of current standards and sanctions. The system, it is argued, is working well, as witnessed by the few proven deviations from normative conduct. Such an assumption unfortunately does not withstand analysis. Although the fear of litigation and potential financial liability has substantially reduced the specter of figurehead directors, it is unclear whether director conduct in major corporations generally involves the degree of due care required by statutory or common-law formulas.¹⁷ Well-recognized restraints upon adequate director participation in major corporate decisions, including deference to perceived management prerogatives, limitations of time, reliance on others for information, and the valued camaraderie of the boardroom,¹⁸ are no less evident today despite the sanitizing shift to outside directors.¹⁹

If compliance with common-law and statutory standards does not explain the absence of successful shareholder litigation and thereby support the maintenance of the status quo, perhaps shareholder suits fail because of judicial antagonism.²⁰ A more likely explanation for the failure rate, however, is a judicial reluctance to impair reputations or to impose potentially severe financial hardships upon defendants who are untainted by improper motivations and who have simply failed to live up to ambiguous standards of care that do not recognize the realities of directors' roles in the management-oriented corporation.²¹ Courts are justifiably sensitive to structural or widely-accepted director constraints. The business judgment rule, defined in its presumptive and broad-reaching defensive manner, thus relieves the courts of the con-

17. See, e.g., *Joy v. North*, 692 F.2d 880, 894 (2d Cir. 1982) (directors were given neither materials nor agendas prior to meetings, and requests for long range planning documents were left unanswered), cert. denied, 103 S. Ct. 1498 (1983).

18. See *infra* text accompanying notes 95-96.

19. See Mace, *Directors: Myth and Reality—Ten Years Later*, 32 RUTGERS L. REV. 293, 297 (1979) ("my conversations with corporate directors and chief executive officers and a reading of the literature has led me to the conclusion that boards of directors operate pretty much as they did ten years ago").

20. Some courts have a distaste for litigation that is motivated primarily by the recovery of sizable attorneys' fees. Dean Eugene Rostow observed that "the law has always had a strong prejudice against those who stir up litigation, or engage in fights which are not, strictly speaking, 'their' business." Rostow, *To Whom and for What Ends is Corporate Management Responsible*, in *THE CORPORATION IN MODERN SOCIETY* 46, 49 (E. Mason ed. 1960).

21. See M. MACE, *DIRECTORS: MYTH AND REALITY* (1971) (discussing the misconceptions surrounding the activities of directors); Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 898 (proposing a "realistic model of directors' behavior" and advocating major reforms in definitions of responsibilities of directors); see also CORPORATE GOVERNANCE, *supra* note 2; authorities cited *infra* note 74; *infra* notes 77-79 and accompanying text.

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cededly difficult task of applying an ambiguous reasonable care standard to the conduct of directors who, contrary to statutory or common-law norms, are often far removed from the epicenter of information and actual decisionmaking.

Judicial concern for directors torn between legal standards and boardroom realities is reflected in *Smith v. Brown-Borhek Co.*,²² a shareholder derivative action against officers and directors of a corporation that had extended more than \$650,000 of credit (80% of its receivables and 63% of its assets) to a single customer who soon thereafter filed a petition for bankruptcy.²³ The plaintiff alleged that the defendants knew of the customer's financial stress, did not adhere to previously set credit limits, and carried the debtor's receivables longer than those of other customers.²⁴ Aggravating the defendants' lack of care was the corporate president's devotion of much of his time during this period to his campaign for mayor, while the vice-president was principally engaged in managing a different business.²⁵ Plaintiff's allegations of negligence were based upon a Pennsylvania statute that required directors to behave with "diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs."²⁶ Instead of focusing on the plaintiff's particular allegations, the court lectured on the perils of the business world by reciting the realities of insolvency and bankruptcy and by warning that a negligence standard, if applied to directors, would make the search for competent directors an impossible task.²⁷ The court then surmised that defendants "had to" have considered the business impact of the credit extension and thus "were indeed managing, as opposed to ignoring, the affairs of their corporation."²⁸ The court's apologia for

22. 414 Pa. 325, 200 A.2d 398 (1964).

23. *Id.* at 328, 200 A.2d at 399.

24. *Id.* at 329, 200 A.2d at 399.

25. *Id.*

26. *Id.* at 331, 200 A.2d at 401. The statute relied upon by the plaintiff, *see* Act of May 5, 1933, No. 106, § 408, 1933 Pa. Laws 390, was amended in 1968 by deleting the words "in their personal business affairs." Act of July 20, 1968, No. 216, § 24, 1968 Pa. Laws 459 (codified as amended at 15 PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1983-1984)). The deleted phrase had been interpreted to create a standard "much more stringent and harsh than the standard enunciated by [Pennsylvania] courts prior to the passage of the statute." *Selheimer v. Manganese Corp. of Am.*, 423 Pa. 563, 573-74, 224 A.2d 634, 640 (1966).

27. It is too often forgotten that all businesses do not flourish, nearly every business has some losses and some bad accounts, and many insolvencies and bankruptcies frequently occur even in these prosperous times. If the test of negligence which is applicable in the field of torts . . . were similarly applicable in the business or banking field, it would *realistically* be very difficult if not almost impossible to secure the services of *able* and *experienced* corporate directors.

Smith, 414 Pa. at 332-33, 200 A.2d at 401 (emphasis in original).

28. *Id.* at 334, 200 A.2d at 402.

the defendants was appropriately characterized by the dissent as an approval of a "failure to even consider the problems of the business."²⁹

The *Smith* decision goes beyond the normal judicial evasion of the negligence standard by both criticizing and ignoring the statutory provision. While the court's frankness may be admired, it is inappropriate for judges to base their decisions on the extent to which imposition of statutory standards would affect the selection process of directors. Even if the application of a negligence standard would deplete the pool of able directors, the resolution lies not in judicial negation of standards but in the legislative realm, where public policy conflicts are best resolved. Nevertheless, the court's attitude illustrates the judicial concerns in this area of litigation,³⁰ and those concerns and other factors preclude a sanguine conclusion that the lack of successful litigation is the result of effective compliance with standards. Rather, a more plausible explanation for the failure rate of shareholder suits is that courts implicitly recognize the difference between what the law requires of directors and the realities that directors face and thus refuse to apply standards that do not reflect those realities. Indeed, resort to the business judgment rule has so altered the inquiry in this area that an independent evaluation of due care by courts often does not occur or is satisfied by cursory reference and analysis.³¹

Despite a judicial reluctance to apply unrealistic standards to directors, one could argue that the paucity of successful reported litigation is tempered by an assumed frequency of favorable settlements obtained by plaintiffs. Yet, even if such settlements are obtained, the argument ignores the minute impact that they have on director behavior. Although there is no adequate guide to either the economic or practical impact of such settlements in due care litigation,³² any impact

29. *Id.* at 339, 200 A.2d at 405 (Cohen, J., dissenting).

30. Since the early period of corporate litigation, courts have expressed concern about the impact of standards on the availability of directors. The New York Court of Appeals, when it considered the degree of care required of bank directors, observed that "[i]f such [a high degree of care and diligence] were required, it would be difficult to find trustees who would incur the responsibility of such trust positions." *Hun v. Cary*, 82 N.Y. 65, 70-71 (1880).

31. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.) (cursory due care analysis), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (due care analysis reversed summarily under the business judgment rule); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982) (ignoring the due care standard); *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706 (N.D. Ill. 1969) (cursory discussion of the due care standard); *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968) (ignoring the due care standard). For a discussion of these judicial errors, see *infra* notes 112-44 and accompanying text.

32. The lack of reliable information about the number of derivative actions settled out of court prompted two authors to argue that "the number of decided cases does not really tell the whole story." *Cary & Harris, Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 Bus. Law. 61, 66 (Officer's and Director's Liability Supp. 1972). In 1980, Professor Jones attempted to supply that information. See *Jones, An Empirical Examination of the*

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is reduced by the ready availability to directors of indemnification and insurance. Moreover, corporate practice reflects a trend toward the use of such protective devices.³³ Chances are remote that we will witness a movement away from broad indemnification and insurance provisions. Shareholder litigation will have an impact on director conduct only when plaintiffs' counsel have greater confidence in pursuing a trial on the merits, leading to decisions that may preclude the application of indemnification provisions.

Criticism of the current use of the due care standard does not mean that the standard itself should be discarded. Rather, good reasons remain for retaining the negligence cause of action and for refining it so that it effectively influences director behavior. Fundamentally, the reasonable care standard is the only control device that can effectively mandate deliberative, rational decisionmaking, a primary duty of directors and officers.³⁴ Only two elements of shareholder control, other than litigation, are theoretically available in cases

Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978, 60 B.U.L. REV. 306 (1980) [hereinafter cited as Jones, *Incidence*]; Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U.L. REV. 542 (1980) [hereinafter cited as Jones, *Resolution*]. The incidence study surveyed 190 publicly held companies. Jones used information contained in periodic SEC filings to chart the filing and disposition of derivative actions. The study revealed, to the surprise of persons concerned about the litigious tendencies of shareholders and attorneys, that the firms "averaged about 1.2 suits for the eight-year period." Jones, *Incidence, supra*, at 313. Although Jones discovered an upward trend in litigation, the increase averaged only 0.2 suits per year for the 190 firms surveyed. *Id.* at 320. The study did not distinguish between the types of actions, although the brief descriptions of the settled suits indicates that most were based on securities laws violations or conflicts of interest. See Jones, *Resolution, supra*, at 547-62. In his analysis of settlements, Jones found that "plaintiffs as a class obtained some relief—settlement, compliance or favorable judgment—in 75.3% (262 of 348) of these suits." *Id.* at 545. The author concluded that "the notion that shareholder plaintiffs rarely obtain relief is clearly a myth." *Id.* The author's conclusions, however, are weakened by the inability to compare settlement recoveries with actual injuries. See *id.* n.4. Moreover, Jones' conclusions are not persuasive for due care litigation, because so few of these cases were surveyed. See *id.* at 547-62.

33. According to one report, 82% of New York Stock Exchange corporations had purchased director's and officer's liability insurance with an average coverage of \$8,000,000. Zonana, *On the Spot*, Wall St. J., July 12, 1976, at 1, col. 6. For discussions of the trend toward broader indemnification provisions, see M. SCHAEFTLER, *LIABILITIES OF OFFICERS: INDEMNIFICATION AND INSURANCE OF DIRECTORS AND OFFICERS* (1976); Bishop, *supra* note 2, at 1081-87. A recent commentator noted that "[g]rowing competition in the insurance industry to write director and officer liability policies has led companies to provide increasingly expansive coverage. Thus, judicial consideration of these policies is likely to occur before long." Oesterle, *Limits on a Corporation's Protection of Its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513, 552.

34. Cf. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (observing that the derivative action is the "chief regulator of corporate management"). Incentive-oriented controls based on noncompensatory concerns, such as status and reputation, or compensatory goals, such as stock values or bonus programs, generally create a unified interest within the trinity of corporation, management, and shareholders. The need for shareholder litigation as a control device arises primarily in those exceptional instances in which competing incentives or personal predilections create a potential imbalance among such trinity of interests. See *supra* note 13; cases cited *infra* notes 116-44.

of negligent management: the shareholder power of removal³⁵ and the threat of hostile takeover.³⁶ Yet, the possibility of shareholder revolt is remote in any sizable corporation with dispersed, fragmented shareholdings, and institutional holders with the economic ability to undertake such a challenge have not taken the lead in this area. The potential for a takeover effort also may be more theoretical than real, since the initiation of a takeover depends upon the size of management's holdings, the adoption of anti-takeover defensive measures, and the economic viability of the mismanaged corporation as an appropriate acquisition.³⁷ Hence, in the absence of a realistic standard of care and effective sanctions to assure compliance, shareholders may have no effective means for the review and policing of management decisions.³⁸ If the current use of the reasonable care standard is unsatisfactory, the answer lies in its reform, not in its abolition. If shareholder litigation is to be an effective element in the overall corporate governance structure, it is in desperate need of reform.

B. Duty of Care—Coming Out from Under the Business Judgment Rule

Directors enjoy substantial immunity from personal liability and are not expected to be insurers of corporate success. All that is asked of directors is that they exercise ordinary, reasonable care.³⁹ Although the

35. See, e.g., DEL. CODE ANN. tit. 8, § 141(k) (1983) (directors can be removed with or without cause by majority shareholder vote); MODEL BUSINESS CORP. ACT § 39 (1979) (same).

36. A poorly managed corporation may become, as a result of market forces, a more likely target for a hostile takeover. See Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 110-13 (1965). Low stock market values and a disgruntled shareholder group are catalysts for acquisitions. *But see infra* note 37 and accompanying text.

37. For example, Warner Communications' recent losses, admittedly due to insufficient control over its Atari subsidiary, have resulted in a substantial drop in the market price of Warner's common stock, which has raised concerns of a potential hostile takeover. The chief executive officer of Warner indicated that Warner might engage in a "friendly, defensive merger . . . to ward off hostile attacks." See Landro, *How Headlines of 1982 Led to 1983's Doldrums for Warner and Atari*, Wall St. J., July 25, 1983, at 1, col. 6.

38. The review mechanism for shareholders appropriately extends only to those primary decisions on which boards are expected to bring their judgment, and not to normal operational decisions or long-term corporate planning, where a board extends more deference to the presumed expertise of officers. See *supra* text accompanying notes 11-12. Derivative actions or other shareholder complaints based on director neglect ought to establish at the outset, beyond mere recitation of statutory formula, that the magnitude or importance of the particular transaction or decision warranted active and deliberative board judgment. See *infra* text accompanying notes 105-07.

39. See authorities cited *supra* note 7. Fletcher defines the duty of care as follows:

The liability of directors and other officers of a corporation is not limited to willful breaches of trust or excess of power, but extends also to negligence. In short, the directors and officers of a corporation must use due care and are liable for their negligence in conducting the affairs of the corporation.

3A W. FLETCHER, *supra* note 8, § 1029.

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definition of that standard may be ambiguous, nothing is expected beyond normal capabilities and competence. The common-law standards of care developed concurrently with the growth of corporations.⁴⁰ Although early cases often involved the management of banks and relied upon concepts from the law of trusts,⁴¹ no court ever gave any indication that an obligation of reasonable care was not equally applicable to industrial concerns.⁴² The doctrine later known as the "business judgment rule" developed concomitantly with reasonable care standards.⁴³ The doctrine was conceived not as a substitute for such standards but as an adjunct to a finding that diligence in the decisionmaking process had in fact been exercised.⁴⁴ If the corporate decisionmaking process met appropriate reasonable care standards, a court would not subsequently entertain the suggestion that it nevertheless should examine the merits of the decision, since such examination would necessarily involve a "business judgment" and intrude upon roles reserved for directors and officers.⁴⁵

The early case of *Hodges v. New England Screw Co.*⁴⁶ illustrates the distinction between due care inquiry and the hands-off doctrine of the business judgment rule. In *Hodges*, directors were charged with an ultra vires purchase of stock of another corporation. The plaintiff alleged violation of the corporate charter on the basis of the general inability of corporations, at that time, to invest in the stock of other companies. The court recognized the violation but refused to hold the directors personally liable on that ground alone. Instead, the court examined the directors' decisionmaking process and articulated the rule that the directors should be held liable if, with due care, they might

40. See, e.g., *Godbold v. Branch Bank*, 11 Ala. 191, 199 (1847) (gross error); *Delano v. Case*, 121 Ill. 247, 249, 12 N.E. 676, 676 (1887) (ordinary care and diligence); *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 74 (La. 1829) (ordinary care and attention); *Charitable Corp. v. Sutton*, [1742] 2 Atk. 400, 406, 26 Eng. Rep. 642, 645 (Ch.) (fidelity and reasonable diligence). See generally *Dyson, The Director's Liability for Negligence*, 40 IND. L.J. 341 (1965) (observing that duty of care developed out of older concepts in the law of trusts and agency).

41. E.g., *Greenfield Sav. Bank v. Abercrombie*, 211 Mass. 252, 256, 97 N.E. 897, 900 (1912); *Hun v. Cary*, 82 N.Y. 65, 70-71 (1880); cf. *Bates v. Dresser*, 251 U.S. 524, 529-31 (1920) (officer put on notice of misappropriation has a duty to investigate).

42. E.g., *Hodges v. New Eng. Screw Co.*, 1 R.I. 312, 346 (1850); see *infra* notes 46-50 and accompanying text.

43. See, e.g., *Smith v. Prattville Mfg. Co.*, 29 Ala. 503, 507-08 (1857) (mere errors of judgment within discretion are not actionable; error must be willful); *Godbold v. Branch Bank*, 11 Ala. 191, 200-01 (1847) (if in good faith and within vested power, no liability for error); *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 78 (La. 1829) (gross error in judgment); *Arsht, The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97-100 (1979).

44. *Arsht, supra* note 43, at 99-100.

45. See *id.* at 95.

46. 1 R.I. 312 (1850).

have avoided the mistake.⁴⁷ Alternatively, if the directors, exercising due care, might not have avoided the mistake, and if they acted in good faith for the benefit of the company, they would not be held liable.⁴⁸ Finding that the legal doctrine on intercorporate investments was not clearly settled and that the directors' investment was in a company "of a kindred nature . . . intimately connected with the business of the Screw Company,"⁴⁹ the court held that the directors' action was based upon an "innocent mistake" for which no liability could attach.⁵⁰ The court's approach indirectly reflects the interaction between standards of diligence and the business judgment rule: lack of sufficient care in the decisionmaking process results in director liability for the mistake; the exercise of due care, even though a mistake was made, invokes the business judgment rule, which protects the defendants as long as "they acted in good faith and for the benefit"⁵¹ of the corporation. The business judgment rule, therefore, protected directors against liability for the adverse consequences of reasonably diligent decisions made in the absence of bad faith, self-dealing, or other improper motive, but was not a substitute for the primary standard of diligence.⁵² Although often overlooked, the key element in references to the "business judgment of directors" is the underlying premise that a *business* judgment, a deliberative decision in accordance with the duty owed to the corporation

47. "If the mistake be such as with proper care might have been avoided, they ought to be liable." *Id.* at 346.

48. "If, on the other hand, the mistake be such as the directors might well make notwithstanding the exercise of proper care, and if they acted in good faith and for the benefit of the Screw Company, they ought not to be liable." *Id.*

49. *Id.* at 348.

50. *Id.*

51. *Id.* at 346.

52. The question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. . . . Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.

Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944). Despite the recognition that the two standards are separate, they often have been melded into one standard. For example, the Delaware Supreme Court articulated the standard in the following manner: "In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the court." *Warshaw v. Calhoun*, 221 A.2d 487, 492-93 (Del. 1966). This formulation, however, was not used to avoid a due care inquiry, for the *Warshaw* court evaluated the record in light of an acknowledged duty of care. In *Warshaw*, the plaintiff challenged a decision by the board to issue stock in a subsidiary and to sell its subscription rights to that stock. The court examined the facts of the sale and concluded that the sale could not be an error in judgment because the sale materially benefited the corporation. *Id.* at 492; see also *Kelly v. Bell*, 254 A.2d 62 (Del. Ch. 1969) (extending the business judgment rule to uphold voluntary corporate payments to county and local taxing authorities on the basis of economic factors examined by the court), *aff'd*, 266 A.2d 878 (Del. 1970).

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and the shareholders, has in fact been made.⁵³

In recent years, the duty of care has been obscured by the judicial tendency to focus primarily on the business judgment rule,⁵⁴ emphasizing elements of conflict of interest or improper motive rather than diligence in the decisionmaking process. This approach adversely affects plaintiffs' already dim prospects for success on a due care theory. Even when courts attempt to articulate the business judgment rule precisely by noting, for example, that it precludes liability for "simply bad judgment," they fail to distinguish lack of diligence in the decisionmaking process or to make clear whether lack of diligence counts as "simply bad judgment."⁵⁵ The business judgment rule as thus expressed and applied in recent decisions does not focus on the process of decisionmaking, but on extraneous factors such as self-dealing, fraud, or illegality. If the so-called rule or presumption is the principal standard for liability, little room is left for inquiry into directors' compliance with statutory or common-law standards of diligence.

Both courts and commentators often overlook the distinction between lack of due care in the decisionmaking process and the business judgment rule when they attempt to justify the current use of the rule.

53. For the business judgment rule to apply, a director must have acted in good faith and with a reasonable basis for believing that the action authorized was in the lawful and legitimate furtherance of the corporation's purposes, and must have exercised his honest business judgment after due consideration of what he reasonably believed to be the relevant factors.

Corporate Director's Guidebook, 33 Bus. Law. 1595, 1604 (1978).

54. Cary and Harris predicted the judicial merger of the due care and business judgment standards: "[T]he distinction between the business judgment rule and the negligence rule . . . which is already somewhat obscure, will largely vanish." Cary & Harris, *supra* note 32, at 70. Even at the time of the prediction, some courts already had obscured the distinction. See, e.g., *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968); *infra* notes 119-26 and accompanying text.

The dominance of the business judgment rule and the decline of independent standards of care are implied by the following passage from *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983):

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duty, all seem to agree that such a statement is misleading. . . . [W]hereas an automobile driver who makes a mistake in judgment . . . will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. . . . [W]hatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.

The court in *Joy* recognized the distinction between a duty of care and the business judgment rule and applied a standard of care that seems even more stringent than the common-law standard. The court's observations are devoid of any suggestion that inquiry is appropriate to determine whether "bad judgment" is the result of a lack of diligence in the decisionmaking process. See *id.* at 886.

55. See *supra* note 54.

For example, the Second Circuit, in *Joy v. North*,⁵⁶ offered the following factors as support for the business judgment rule: the voluntary undertaking by shareholders of the risk of bad business judgments; the recognition by courts that after-the-fact litigation "is a most imperfect device to evaluate corporate business decisions";⁵⁷ and the avoidance of "incentives for overly cautious corporate decisions."⁵⁸ These reasons, however, are inadequate to justify limitations on judicial inquiry into whether directors have made business decisions through deliberative means. The shareholder's risk of bad business judgments is irrelevant to the directors' duty of care. Although deliberative processes may tend to prevent bad business decisions, they are no guarantee against them. Reasonable care, therefore, is not determined by evaluating the merits of board decisions. The problem of judicial evaluation by hindsight is similarly not a reason to avoid the diligence inquiry, but it is an appropriate reminder to courts and litigants to consider the pressures of time and limited resources that affect the decisionmaking process.⁵⁹ Directors cannot be faulted for a hasty decision or for one that is made without fullest information when such haste or lack of inquiry could not reasonably have been avoided.⁶⁰ Additionally, standards of care need not quell director initiative. They establish only a minimum requirement of prudent conduct in investigation and decisionmaking. Finally, it seems implausible to suggest that shareholders, willing to assume some risks of bad judgment, are equally willing to assume those risks at the hands of directors not charged with some form of reasonable diligence under the circumstances.⁶¹

The distinction between inquiry into the decisionmaking process

56. 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).

57. *Id.* at 886.

58. *Id.*

59. See *infra* notes 88-94 and accompanying text.

60. See *United States Smelting, Ref. & Mining Co. v. Clevite Corp.*, [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,047 (N.D. Ohio June 17, 1968) (quick decision to oppose a hostile tender offer was a valid business judgment in light of the exigent circumstances); *Bennett v. Propp*, 41 Del. Ch. 14, 23-24, 187 A.2d 405, 410 (1962) (time pressure excused directors from duty to investigate alternatives).

61. Professors Easterbrook and Fischel offer an interesting cost-benefit analysis of the decisionmaking process to justify informational shortcomings. After observing that many corporate decisions are based on inconclusive information, the authors surmise that "rational shareholders would not have it otherwise, however, for their welfare is maximized by decisions that yield the highest profits net of the costs of gathering information and making the decisions." Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1196 (1981). Similarly, they argue that cost savings justify the avoidance of a judicial inquiry into such matters: "Although sometimes a court might be able to detect inferior decisionmaking or other agency costs, the burden of inquiry in the run of cases almost certainly would carry costs larger than the gains available in the few cases where courts could improve matters." *Id.* Although these comments are true of relatively unimportant decisions, the authors' observations, without empirical data to support their cost-based analysis, are of limited value in areas of

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and the business judgment rule is also blurred by recitation of a presumed lack of judicial ability to comprehend the complexities of the commercial world.⁶² For example, Professors Easterbrook and Fischel recently argued that "there is no reason to think that courts generally could improve the performance of managers. Courts lack the experience and information necessary to make business decisions."⁶³ This defense of judicial passivity overlooks numerous instances in which courts competently evaluate difficult factual questions in the business world. Moreover, the argument that courts should not try to improve upon the performance of managers addresses a false issue. The issue in duty of care litigation is the process, not the merits, of decisionmaking. Courts do not make business decisions. They evaluate board procedure, a matter well within judicial competence.

Pointing out the way in which the distinction between the business judgment rule and the duty of reasonable care is often obscured is insufficient to bring about the reform of the judicial application of the rule. If the misuse of the business judgment rule derives from judicial reluctance to apply ambiguous and unrealistic standards and sanctions to directors,⁶⁴ an examination of the ambiguities of the standard and the realities of the role of directors is the first step in reformulating a realistic standard. The inquiry is best directed to whether statutory and common-law norms can be formed into boundaries more appropriate to directors' roles in management-oriented corporations. Lawyers for too long have sought to force the round pegs of broad negligence standards into the square holes of directors' limited corporate responsibilities.

III. A Redefinition of the Reasonable Care Standard

A. *Problems of Definition: Precision and the Realities of Directors' Roles*

The dominance of the business judgment rule derives from two independent judicial concerns: (1) the content and scope of diligence standards, and (2) the sanctions applied for violations of those standards. Judicial reluctance to employ the negligence cause of action is

major corporate concern, where it is difficult to project transaction costs that amount to a significant fraction of the economic consequences of board action.

62. See, e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 632, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) ("[T]he business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments."); see also Easterbrook & Fischel, *supra* note 61, at 1196.

63. Easterbrook & Fischel, *supra* note 61, at 1196.

64. See *supra* notes 20-31 and accompanying text.

but the natural response of courts faced with the dilemma of imposing severe financial hardships on the basis of standards that are at best ambiguous.⁶⁵

Application of current standards of care often involves a search for precision, encompassing such issues as whether ordinary or gross negligence is the threshold for liability,⁶⁶ whether the requirement that a director "reasonably believe" that he is acting in the best interest of the corporation turns on a subjective or an objective standard,⁶⁷ what the role of "good faith" is with respect to the decisionmaking process,⁶⁸ whether good faith is an adequate substitute for factual investigation, and whether appropriate distinctions can be drawn between inside and outside directors.⁶⁹ The ever-increasing multitude of questions concerning the definition of due care contributes to, rather than diminishes, current confusion. This problem is aptly illustrated by the recently published debates between distinguished members of the Delaware bar as to whether Section 35 of the Model Business Corporation Act departs from or reflects the common-law standards of Delaware.⁷⁰ Given the current absence of definitional precision, it is understandable that courts avoid imposing liability unless there is a clear disregard of duty.

An equally troublesome aspect of defining an adequate standard of care is the extent to which formal standards differ from the realities

65. See, e.g., *Smith v. Brown-Borhek Co.*, 414 Pa. 325, 333, 200 A.2d 398, 401 (1964) (the fear of damages from ordinary negligence actions would make it difficult to find good directors); cf. authorities cited *infra* note 185 (courts are reluctant to impose fully compensatory damages on federal securities law violators because of the potential magnitude of the damages).

66. See, e.g., Rhoads, *Personal Liability of Directors for Corporate Mismanagement*, 65 U. PA. L. REV. 128, 129-38 (1916).

67. "The significant question is whether courts are equipped to pass on the 'reasonableness' of these subjective beliefs or should limit their inquiry to director behavior capable of objective measurement." Veasey & Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 939-40 (1980).

68. See, e.g., *Royal Indus. v. Monogram Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,131 (C.D. Cal. Nov. 29, 1976) (an investigation undertaken only to create the impression of diligence does not satisfy the due care standard).

69. The distinction between inside and outside directors has been drawn most fully in securities cases. See, e.g., *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). In duty of care and business judgment jurisprudence, however, the focus is usually upon the access to or knowledge of relevant information, rather than upon a director's status; this has fostered the development of the "independent directors" concept. See generally A. COHEN & R. LOEB, *DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS* (1978); Brudney, *supra* note 3.

70. Compare Veasey & Manning, *supra* note 67, at 931 ("It is with respect to that factor—the relative restraint with which courts may inquire into the merits of business decisions—that Section 35 MBCA and Delaware law differ most significantly."), with Arshat & Hinsey, *Codified Standard—Same Harbor But Charted Channel: A Response*, 35 BUS. LAW. 947, 961 (1980) ("Section 35 would not create, at least with respect to Delaware law, any new area of judicial inquiry where a court is called upon to review the performance of directors.").

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of the boardroom process. Negligence concepts developed at a time when directors may actually have been, and were certainly regarded as, the primary decisionmakers within the corporation. But the trend in recent years to an increasing percentage of outside directors, or directors not involved in the operational aspects of the corporation, strains beyond reasonable accommodation the conception of directors as primary decisionmakers. The misguided assumptions underlying current standards were identified long ago as contrary to the reality of corporate decisionmaking. Well before Professors Berle and Means published their findings regarding the consequences of the separation of corporate ownership from control,⁷¹ legal scholarship reflected concerns about directors' roles. A 1914 article attributed the cause of corporate losses to the fact that "men have felt justified in undertaking more directorships than they could possibly understand or give their attention to."⁷² A commentator in 1907 foresaw corporate and societal gains if "the prodigious number of pseudo-directors who are now in evidence were 'squeezed out,' and a really hard working director became less of an anomaly than he seems under present conditions."⁷³ Moreover, current analysts of corporate structure and conduct continue to address basic questions of the division of responsibilities between managers and directors.⁷⁴ Despite recent criticism that legal scholarship does not examine "the ways in which large corporations are actually governed and how business judgment is actually exercised,"⁷⁵ failure to incorporate a realistic conception of the role of directors into

71. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

72. Lynch, *Diligence of Directors in the Management of Corporations*, 3 CALIF. L. REV. 21, 40 (1914).

73. Dwight, *Liability of Corporate Directors*, 17 YALE L.J. 33, 42 (1907) (emphasis omitted).

74. See M. EISENBERG, *THE STRUCTURE OF THE CORPORATION—A LEGAL ANALYSIS* (1976); M. MACE, *supra* note 21; M. SCHAEFTLER, *supra* note 33; Boulton, *The Evolving Board: A Look at the Board's Changing Roles and Information Needs*, 3 ACAD. MGMT. REV. 827 (1978); Conard, *supra* note 21; Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981); Knauss, *Corporate Governance—A Moving Target*, 79 MICH. L. REV. 478 (1981); Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505 (1980); Mace, *supra* note 19; Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Palmieri, *Corporate Responsibility and the Competent Board*, HARV. BUS. REV., May-June 1979, at 46; Schwartz, *Practical Impact of Fiduciary Standards*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 199, (D. Schwartz ed. 1979); Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611 (1981); Wommack, *supra* note 12; *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation—Statement of the Business Roundtable*, 33 BUS. LAW. 2083 (1978); *Corporate Director's Guidebook*, *supra* note 53; Note, *supra* note 3.

75. Andrews, *Rigid Rules Will Not Make Good Boards*, HARV. BUS. REV., Nov.-Dec. 1982, at 42 (criticizing recent draft of ALI on corporate governance); accord STATEMENT OF THE BUSINESS ROUNDTABLE, *supra* note 11, at 20.

a standard of diligence is not the result of a lack of study.⁷⁶

The continued vitality of unrealistic, ambiguous standards of diligence stems from the failure of legal and corporate process to apply the findings of scholarship to the interpretation or reform of statutory standards. Over a decade has passed since Myles Mace reported on the misconceptions surrounding what directors do and, equally important, do not do.⁷⁷ A like time has passed since Professor Conard, examining a "realistic model of directors' behavior," concluded that major reforms were needed to revitalize the derivative action, including a clearer demarcation of roles and alternate selection processes for outside and inside directors.⁷⁸ Recent years have seen no abatement in research, analysis, and proposals regarding director conduct and appropriate legal response.⁷⁹ Despite these efforts, a gulf remains between statute and practice. The only perceptible change in statutory standards in recent years is the enigmatic amendment that the corporation is to be managed by "or under the authority of" the board.⁸⁰ Yet this change was intended to insulate directors from the natural consequences of their delegation of authority to corporate officers⁸¹ and offers insufficient content for a due care standard. The phrase "under the direction of" is plausibly read to demand either an active role in the supervision of officers' functions and duties, or a passive, delegation-oriented role. Unquestionably there are boards that meet each of these descriptions and numerous variations, but however the statutory formulation is phrased, the norm is that large corporations operate almost totally through management and leave directors in a kind of Valhalla to consider only the most fundamental corporate issues.⁸²

It should be apparent to reformers in the legal community that no amount of critique or commentary will materially change the manner

76. On the contrary, the literature on corporate governance is copious. See authorities cited *supra* note 74.

77. See M. MACE, *supra* note 21.

78. Conard, *supra* note 21, at 898.

79. See, e.g., CORPORATE GOVERNANCE, *supra* note 2.

80. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1983). Section 35 of the MBCA was amended in 1974 to insert the phrases "or under the authority of" and "under the direction of" in the description of management powers of the board. See *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501, 504-05 (1975). The committee noted that the prior formulation, which states that the corporation shall be "managed" by the board, "does not accord with the realities of today's corporation (particularly the large diversified enterprise) and should be clarified." *Id.* at 505.

81. See *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, *supra* note 80, at 505.

82. For example, the court in *Kelly v. Bell*, 254 A.2d 62 (Del. Ch. 1968), addressing the issue of U.S. Steel's directors' lack of knowledge of challenged corporate payments, observed that "the magnitude of Steel's operations requires substantial delegation. And that is as permissible in law as it is necessary in fact." *Id.* at 72.

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in which management uses directors in major corporations.⁸³ The degree of passivity or activity of a board will inevitably vary among corporations. Management reliance on boards is a function of personality and technique rather than adherence to stated legal norms. Myles Mace categorized chief executive officers as those who "regard their board as an unnecessary legal appendage,"⁸⁴ those with a willingness to consider advisory suggestions,⁸⁵ and those who "choose to include the board as a major and important element in the management structure."⁸⁶ Whatever the practice, it is the choice of management, not the board. The normative response of directors unhappy with their lot is to resign.⁸⁷

The dominance of management is the consequence of several factors, including access to information, control of data, presumed expertise, immediacy of decisionmaking, and constraints inherent in the sporadic, distanced involvement of outside directors.⁸⁸ A major study nearly forty years ago concluded:

The economics of the large corporation makes inevitable the centralizing of active leadership in the hands of full-time management officials. It is therefore not necessary, and it would probably be inimical to effective and coordinated decisionmaking, to attempt to push the board of directors into active and continuous participation in the performance of the leadership function.⁸⁹

83. See Mace, *supra* note 19, at 297.

84. M. MACE, *supra* note 21, at 193.

85. See *id.*

86. *Id.* at 194; see also Boulton, *supra* note 74, at 834 ("The change in CEO leadership can alter the nature of the discussion from one of ratifying decisions to one of discussing more tentative ideas").

87. M. MACE, *supra* note 21, at 183. After resigning from the Board of Trans World Airlines (following an unsuccessful attempt to establish a management review committee of outside directors), Arthur Goldberg expressed his frustrations:

Contrary to legal theory, the boards of directors of most of our larger companies do not in fact control and manage their companies, nor are they equipped to do so. Instead, the management hired by the board, presumably to execute decisions of the board, in fact generally decides the course of operations and periodically requests the board to confirm the determinations of the management

Goldberg, *Debate on Outside Directors*, N.Y. Times, Oct. 29, 1972, § 3, at 1, col. 2; see also *Holly Sugar Chairman is Seen Waging More Battles After Winning Proxy Fight*, Wall St. J., Mar. 14, 1983, at 8, col. 2 (dissident director "so disillusioned" by president's actions that he will not seek reelection); *Corporate Director's Guidebook*, *supra* note 53, at 1602 (director whose request for delay to obtain further information is denied "should consider the need for his resignation").

88. Professor Letts has suggested that "[t]he primary element of the chief executive's strength" derives from the lack of contact between directors and lower level management, which may lead each group to assume that the other supports the CEO and to fear appearing disloyal in the face of solid support. See Letts, *supra* note 74, at 1509.

89. R. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* 347 (2d ed. 1961). Professor Eisenberg has proposed an intermediate role between active control and extensive delegation for boards of directors. See M. EISENBERG, *supra* note 74, at 162-70. His model of corpo-

Directors are even further removed from authority in major corporations that reflect a decentralization of management among what John Kenneth Galbraith has called the "technostructure."⁹⁰ The reality of the structural constraints on director involvement thus belies the statutory admonition that corporations are managed by or under the direction of the board of directors. The fiction is aggravated beyond tolerance by the attempted application of ambiguous negligence concepts to measure the liability of director conduct.⁹¹

The limitations on participation and influence by directors may be summarized as follows: (1) directors cannot reasonably be expected to be aware or have working knowledge of matters not of material, central importance to the corporate welfare; (2) directors necessarily rely on officers, employees, and corporate consultants for information and expert advice; (3) most major transactions are extensively examined and considered by management prior to recommendation to the board;⁹² (4) the board is not well suited for effectively making rapid or emergency decisions. An adequate standard of care would permit any of these limitations to be legitimately raised by defendant directors in due care proceedings. Other factors that might be significant in the circumstances of a particular decisionmaking process include the division of responsibilities through board committees⁹³ and the availability to directors of relevant corporate data in publicly issued documents.⁹⁴ Some real or imagined limitations, however, must be viewed with skepticism. For example, the "common culture" of the boardroom dictates that disputes are to be avoided⁹⁵ and that questions embarrassing to corporate officers are to be withheld,⁹⁶ but such limitations are fundamentally inconsistent with diligence in a board's decisionmaking. Similarly, the demands of time may be a two-edged sword. Haste may

rate governance, however, stresses the board's role in selection, evaluation, and removal of principal executives. *See id.* The model does not extend to the board's control over corporate decisionmaking, according to Professor Eisenberg, because internal restraints render a board's activities "of little importance" in this area. *Id.* at 159.

90. *See* J. GALBRAITH, *THE NEW INDUSTRIAL STATE* 62-74 (3d ed. 1978).

91. *See supra* text accompanying notes 65-76.

92. *See* Note, *supra* note 3, at 1896-1902.

93. *See* Schwartz, *supra* note 74, at 199-200.

94. *See* Cary & Harris, *supra* note 32, at 70 ("[T]he availability to the public [of] an ever-increasing volume of facts and figures . . . will move the courts to focus more upon the necessity of adequate information in the hands of directors before business judgments can properly be exercised.")

95. *See* Brudney, *supra* note 3, at 612-13; Coffee & Schwartz, *supra* note 4, at 283-84 & *im.* 124-27; Note, *supra* note 3, at 1898-1901.

96. *See* M. MACE, *supra* note 21, at 186-87 ("Board meetings are not regarded as proper forums for discussions arising out of questions asked by board members. It is felt that board meetings are not intended as debating societies.")

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absolve lack of careful investigation in some circumstances,⁹⁷ but in others it might raise doubt about the adequacy of the decisionmaking process.⁹⁸ Nor are multiple directorships an excuse for haste. Because election to a directorship carries an implicit commitment of the time necessary to fulfill its functions, self-imposed constraints on time that undercut such commitment can scarcely be a good faith ground for avoidance of duties.⁹⁹

B. Definition of the Reasonable Care Standard

In light of the limitations on director participation in corporate governance and the problems of current standards of diligence and reasonable care, what minimum standards of conduct are shareholders entitled to expect from their elected directors? Phrased differently, what is the minimum legal standard of diligence that courts should apply to directors in their limited role as corporate decisionmakers? Only two elements appear fundamental to a realistic standard of care, and these two elements alone ought to define the limits of due care. The first is an alertness to potentially significant corporate problems. The second is an obligation of deliberative decisionmaking on issues of fundamental corporate concern.

1. Alertness to Potentially Significant Concerns.—Alertness to potential corporate problems involves skills no greater than ordinary intelligence and perception. This element of care is well recognized, dating from the earliest recorded cases of director misconduct.¹⁰⁰ Learned Hand regarded its neglect as “misprision of office” in *Barnes v. Andrews*,¹⁰¹ in which a director had avoided all but minimal inquiry

97. See, e.g., *United States Smelting, Ref. & Mining Co. v. Clevite Corp.*, [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,047 (N.D. Ohio June 17, 1968). Noting the time pressures placed on target management by a hostile tender offer, the court found the board's hasty decision to combat the offer consistent with valid business judgment in light of the “exigencies of the situation.” *Id.*; see also *Bennett v. Propp*, 41 Del. Ch. 14, 23-24, 187 A.2d 405, 410 (1962).

98. See, e.g., *Treadway Cos. v. Care Corp.*, 490 F. Supp. 668, 686 (S.D.N.Y.) (board investigation of a tender offer inadequate in light of “haste (to the exclusion of potentially more lucrative offers)” with which sale and earlier transactions were negotiated), *aff'd in part, rev'd in part*, 638 F.2d 357 (2d Cir. 1980).

99. Roger Blough, former chairman of the board of U.S. Steel, estimated that outside directors of major corporations spend 150-250 hours per year on corporate matters, including travel. See Blough, *The Outside Director at Work on the Board*, 45 N.Y. St. B.J. 467, 474 (1973). Blough concluded that “individuals with a large number of directorships would have difficulty spending much time annually on the affairs of any given corporation.” *Id.*

100. See, e.g., *Smith v. Prattville Mfg. Co.*, 29 Ala. 503 (1857); *Godbold v. Branch Bank*, 11 Ala. 191 (1847); *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829); *Charitable Corp. v. Sutton*, [1742] 2 Atk. 400, 26 Eng. Rep. 642.

101. 298 F. 614, 616 (S.D.N.Y. 1924).

into corporate affairs. Disagreement between the district court and the Supreme Court in *Bates v. Dresser*¹⁰² involved only the degree of care required of bank directors who failed to detect employee embezzlement, not the obligation of the directors to be alert to such problems. The district court, following a thorough review of the facts, found it "inconceivable" that the directors could have undertaken sufficient investigation of the bank's declining financial condition.¹⁰³ Justice Holmes, writing for the Court, stressed the novelty of the fraudulent method used, the difficulty of its discovery, and the periodic reviews by national bank examiners as factors that excused the failure of the directors to detect the embezzlement and seemed to warrant the directors' confidence.¹⁰⁴

Alertness is unquestionably a matter of degree. It would be foolish to require directors to monitor every potential problem area within corporate operations. Certain matters, however, such as shifts in control or major redirection of assets,¹⁰⁵ inevitably call for director inquiry. Moreover, it is reasonable to expect directors to seek periodic reports concerning significant regulatory matters when industry practice or company history indicates cause for concern as to compliance. For example, directors of major industrial firms should inquire into and receive reports on questions of environmental concern.¹⁰⁶ Those same directors, however, in the absence of facts alerting them to a significant problem, should not be faulted for failure to discover regulatory violations of which they have no reason to be aware. To insist upon ordinary notions of inquiry and concern relieves the tension between the theory and reality of directors' roles. Neither courts nor shareholders cognizant of the dependent, distanced status of directors in most large corporations are likely to require unreasonable perspicacity concerning

102. 229 F. 772 (D. Mass. 1915), *rev'd*, 250 F. 525 (1st Cir. 1918), *aff'd*, 251 U.S. 524 (1920).

103. *See* 229 F. at 792.

104. *See* 250 F. at 530.

105. For example, in *DePinto v. Provident Sec. Life Ins. Co.*, 374 F.2d 37 (9th Cir.), *cert. denied*, 389 U.S. 822 (1967), an independent outside director was held liable for \$315,000 because he did not evaluate a transaction that changed corporate control. DePinto resigned from the board at the request of the controlling shareholder who was selling his interest in connection with the corporate purchase of stock in an acquiring company. *See id.* at 41-42. The Ninth Circuit affirmed that DePinto was negligent due to his

failure to make a reasonable investigation as to whether the ultimate plan would adversely affect United, his resignation from the board of directors in compliance with Kelly's request and without having made such an investigation, and his failure, as a member of the board of United, to fight for the best interests of United.

Id. at 44.

106. In 1978, the Environmental Protection Agency filed its fifth lawsuit in eight years against U.S. Steel for the alleged "long standing air pollution" caused by its Gary, Indiana, mill. *See* Wall St. J., Dec. 28, 1978, at 24, col. 2.

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potential corporate problems.¹⁰⁷ Directors would be impossibly burdened if it were Sherlock Holmes, not Oliver Wendell, whose precepts set the standards.

2. *Deliberative Decisionmaking.*—The second element of reasonable care, deliberative decisionmaking,¹⁰⁸ presents far more difficult problems of analysis. Here the concern is one of process: Have the directors sought adequate information? If so, is the decision or action by the board consistent with a significant portion of such information? Although these inquiries are relevant to any board action, liability generally should not be imposed when the board's role is principally advisory. For the vast majority of operational decisions, such as budget reviews, research and development projects, and corporate strategies, the board is merely an advisor,¹⁰⁹ since management is hired for its expertise in these matters. If discussions of these concerns become laden with potential director liability, neither management nor the di-

107. See, e.g., *Deal v. Johnson*, 362 So. 2d 214 (Ala. 1978) (directors' lack of awareness of president's improper use of corporate funds excused because directors sought and received corporate information, including assurances from an outside accountant).

Occasionally, courts face the issue of whether a particular director's action should be judged in light of the perceived abilities of that director or against a higher, objective standard of reasonableness. For example, in *Allied Freightways v. Cholfin*, 325 Mass. 630, 91 N.E.2d 765 (1950), the court referred to the defendant director, who was also the wife of the principal shareholder and president, as someone who "might have been an ordinary housewife with no business experience, so far as anything appears in the evidence," *id.* at 768, and apparently exonerated her for her failure to discover her husband's misuse of corporate funds. Whether the court used a standard based on the particular director's capabilities is in doubt, since the court also emphasized that even the corporate bookkeeper was unaware of the improper withdrawals. See *id.* Similarly, in *Anderson v. Akers*, 7 F. Supp. 924 (W.D. Ky. 1934), *modified on other grounds sub nom.* *Atherton v. Anderson*, 86 F.2d 518 (6th Cir. 1936), two of the nonofficer bank directors were found to be of "unsound mind during the entire time they were on the board" and were excused from the liability imposed on their codirectors for the ultra vires acts of the bank. *Id.* at 936. Unfortunately, the record does not reveal the undoubtedly strange reasons why these persons were serving on the board. *Akers*, however, is a rarity because courts usually insist that all directors meet a reasonably objective standard of diligence. See, e.g., *Gamble v. Brown*, 29 F.2d 366, 373 (4th Cir. 1928) (special defense of age, increasing bodily and mental infirmities and illiteracy rejected for a director who "nevertheless voluntarily remained in office"). One commentator concluded that "the cases tacitly agree that a director may be incompetent as long as he is diligent and prudent. But where he is negligent, the better rule is that incompetence is no excuse." Dyson, *supra* note 40, at 367.

108. The term "deliberative" has been deleted from the phrase "deliberative business decisions" in the ALI's commentary. See CORPORATE GOVERNANCE, *supra* note 2, § 4.01(d); Memorandum to American Law Institute members from Roswell B. Perkins, President of the ALI (Apr. 5, 1983) (written version of remarks on background and status of ALI Corporate Governance project), at 9 (copy on file with the *Texas Law Review*). The purpose of this change is unclear because the draft continues to refer to decisions "in which judgment has in fact been exercised." *Id.* The reviser deleted the term presumably because businessmen and others believed that the word "deliberative" connotes a more searching, investigatory, and analytical process than actually occurs. See *id.* Similar concerns led to the recommended substitution of the term "oversee" for "monitor" in describing board activities. See *id.* at app. 1.

109. See Haft, *supra* note 74, at 4.

rectors will find it efficient or desirable to use the board's advisory powers. Emphasis on deliberative decisionmaking should be reserved for issues of material corporate importance involving structural or personnel matters, such as mergers, sale of significant assets, issuance of shares, and appointment of principal officers. These matters are delegated to the board by statute, reflecting a legislative intent that board evaluation be independent.¹¹⁰ Similarly, independent board evaluation should be expected for issues that affect the control of management, such as a response to a tender offer or the undertaking of short- or long-term defensive measures.¹¹¹ Neither passive acquiescence to executive officers by the board nor application of the narrow business judgment rule by the court are appropriate when fundamental corporate concerns are at stake.

(a) *Adequacy of information.*—Directors should not be faulted if they are reasonably unable to determine the validity or adequacy of information received from management counsel or consultants. Directors necessarily rely on others in most instances to provide information and cannot ensure its accuracy. State statutes, therefore, appropriately immunize "good faith" reliance.¹¹² Dependency, however, should not shield neglect. Shareholders are entitled to expect that directors will use judgment in ascertaining whether additional information or further study is necessary under the circumstances. Although directors generally might avoid asking questions that are probing and discerning,¹¹³ such reticence is wholly inappropriate when directors face important issues for which clearly insufficient information has been provided.¹¹⁴ Indeed, it is precisely in times of corporate stress when major issues are considered that directors should recognize the personal stake of management and subordinates and be particularly alert to problems of information control.¹¹⁵ Nonetheless, courts con-

110. See, e.g., DEL. CODE ANN. tit. 8, §§ 142, 152, 251, 253, 271 (1983) (delegating to the board, respectively, decisions concerning selection of officers, issuance of stock, mergers or consolidation, mergers with subsidiary, sales or exchanges of assets).

111. See, e.g., Brudney, *supra* note 3, at 628-30.

112. See, e.g., DEL. CODE ANN. tit. 8, § 141(e) (1983); MODEL BUSINESS CORP. ACT § 48(c) (1979).

113. See M. MACE, *supra* note 21, at 187.

114. In *Royal Indus. v. Monogram Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,131 (C.D. Cal. Nov. 29, 1976), the court held that a corporate press release, which stated that the board of directors "was guided in its decision to reject the tender offer by an evaluation prepared by Dean Witter & Co.," was materially misleading because the board knew that the Dean Witter report was prepared "virtually overnight and without the necessary time and deliberation for a fair evaluation." *Id.* at 91,139.

115. For example, the decline of Penn Central was accelerated by the substantial cash dividends that were paid almost until bankruptcy was filed. In each instance, the board's finance

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tinue to avoid inquiry into the decisionmaking processes of boards by ignoring any requirement of due care in deliberation, by paying only cursory attention to directors' processes of decisionmaking, or by inquiring into those processes and then retreating to the business judgment rule. *Shlensky v. Wrigley*,¹¹⁶ *Panter v. Marshall Field & Co.*,¹¹⁷ and *Gimbel v. Signal Cos.*¹¹⁸ illustrate respectively each of these judicial approaches.

In *Shlensky*, plaintiff filed a derivative action challenging the lighting policy at Wrigley Field, home of the Chicago Cubs baseball team.¹¹⁹ Because the team played no home games at night, many working people and students were unable to patronize the team. The plaintiff alleged that the lighting policy adversely affected the corporation's primary source of revenue, sale of tickets to home games, and thus caused the corporation to suffer a substantial economic loss.¹²⁰ Philip K. Wrigley, controlling shareholder, president, and director of Chicago National League Ball Club, Inc., which owned the Cubs, controlled the election of each of the other eight directors, who were, along with Wrigley, defendants in the suit. Apparently the full board had never seriously considered the policy of playing home games at night,¹²¹ and Wrigley had eschewed the policy because of his belief that baseball was "a daytime sport" and that night games would cause the neighborhood surrounding the stadium to deteriorate.¹²² Although the plaintiff argued that Wrigley's personal opinions were irrelevant to the corporation's business interests and welfare,¹²³ the trial court granted defendant's motion to dismiss the complaint, and the dismissal was affirmed on appeal.¹²⁴

The *Shlensky* opinion illustrates the judicial proclivity to take refuge in the business judgment rule. Relying upon Delaware case law for

committee adopted management's recommendations without question, despite the fact that "as the financial condition of the Railroad deteriorated, the amount of financial information supplied . . . lessened noticeably." See STAFF OF HOUSE COMM. ON BANKING AND CURRENCY, 92D CONG., 1ST SESS., REPORT ON THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS 180 (Comm. Print 1972).

116. 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).

117. 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

118. 316 A.2d 599 (Del. Ch.), aff'd per curiam, 316 A.2d 619 (Del. 1974).

119. When this suit was filed, the Chicago Cubs were (and still are) the only major league baseball team without a stadium equipped with lights. In fact, by 1966 over one-half of all major league games were scheduled at night. See 95 Ill. App. 2d at 175, 237 N.E.2d at 777.

120. For the five years ending in 1965, the loss from baseball operations exceeded \$4,500,000. Brief for Appellant at 10, *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).

121. 95 Ill. App. 2d at 176-77, 237 N.E.2d at 778.

122. *Id.* at 176, 237 N.E.2d at 778.

123. *Id.* at 177, 237 N.E.2d at 778.

124. *Id.* at 174, 183, 237 N.E.2d at 777, 781.

the proposition that “[t]he judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve,”¹²⁵ the court ignored the fact that the presumption of good faith is based upon the preexistence of a *business* judgment¹²⁶ and did not consider whether the directors engaged in any investigation or research of the facts. Hence, not only does the opinion presume a decision by directors, but it also fails to consider whether such decision stemmed from an adequate factual basis. Had the directors investigated the facts and then concluded that the information supported a policy against night games, the business judgment rule would appropriately shield the directors’ decision against shareholder allegations, even if the facts also supported a different decision. The *Shlensky* court, however, completely ignored the basic premise underlying the business judgment rule.

Slightly more, but still inadequate, attention to the decisionmaking process is evidenced in *Panter v. Marshall Field & Co.*¹²⁷ Shareholders initiated litigation after Marshall Field successfully thwarted a hostile tender offer planned by Carter Hawley Hale (CHH). Marshall Field’s success denied shareholders the opportunity to tender their shares at the intended offering price of \$42, which was well above the market price per share prior to the tender offer announcement.¹²⁸ The plaintiffs asserted state and federal claims against the corporation and its directors in an effort to recover their “lost” premium. The principal state law claim related to whether two of Marshall Field’s defensive measures, the acquisition of stores in CHH’s marketing areas and the prosecution of antitrust claims concerning the proposed CHH takeover, were based on a genuine concern for the merits of the tender offer or were motivated primarily by management’s desire for continued corporate control.¹²⁹

The majority and dissenting opinions in *Panter* illustrate contrasting judicial approaches to examination of the decisionmaking processes of directors. Given the nature of plaintiffs’ claims, the fundamental focus of judicial concern should have been the process of information-gathering and decisionmaking that led Marshall Field to engage in the defensive measures. The majority in *Panter*, however, quoting the dis-

125. *Id.* at 178, 237 N.E.2d at 779 (quoting *Davis v. Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928)).

126. *See Corporate Director’s Guidebook*, *supra* note 53, at 1604.

127. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

128. *See id.* at 280.

129. *See id.* at 293-94.

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strict court,¹³⁰ gave the barest and most inadequate consideration to the decisionmaking process and instead immediately invoked the business judgment rule:

Directors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. When they act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions. In the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.¹³¹

Under this approach, plaintiffs' claim fails unless plaintiffs are able to adduce evidence "from which a factfinder might infer that impermissible motives predominated in the making of the decision in question."¹³² Thus, even evidence of a motive to retain control of the corporation is insufficient unless that motive is predominant in the directors' decision.

The majority's analysis ignores the underlying issue of whether the directors made any *business* judgment at all. The trial court, impressed by nothing more than an oral opinion prepared and presented by Marshall Field's outside counsel, concluded that there were "valid reasons to believe that any merger of Field with CHH would violate the anti-trust laws, and the subject, over a period of more than a month, was studied and discussed by Field executives with qualified lawyers."¹³³ Despite Field's explicit pattern over many years of rejecting all overtures of takeover or merger,¹³⁴ the trial court engaged in only cursory analysis of the record in reviewing the adequacy of the so-called business judgment in these circumstances. Even a superficial examination reveals serious questions concerning the adequacy of information provided to the directors, the directors' lack of diligence in pursuing material information, and their willingness to make decisions without the degree of study undertaken in more ordinary circumstances.¹³⁵ At the

130. 486 F. Supp. 1168, 1194 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

131. 646 F.2d at 293 (citations omitted).

132. *Id.* at 294 (quoting *Johnson v. Trueblood*, 629 F.2d 287, 292-93 (3d Cir. 1980) (emphasis omitted), *cert. denied*, 450 U.S. 999 (1981)).

133. 486 F. Supp. at 1194.

134. Management's commitment to remain independent had been "expressed so many times that at least two directors . . . recall it being stated as a policy." *Id.* at 1177.

135. The antitrust concerns were fairly narrow in scope. Only three problems existed: (1) one instance of overlapping stores in a suburban Chicago shopping center; (2) potential competition on two future sites; and (3) existing competition in the retail sale of books. *See id.* at 1180. The directors, however, made no effort to consider whether the antitrust concerns could be resolved

appellate level, only Judge Cudahy, in his partial dissent, examined thoroughly the directors' process of decisionmaking,¹³⁶ by concentrating on the factual basis of the directors' decision. Based on his review of the record, Judge Cudahy concluded that plaintiffs had "presented extensive evidence to substantiate their claims that Field's board gave the CHH merger proposal no bona fide consideration."¹³⁷

A similar failure to focus on the process of decisionmaking is reflected in *Treadway Cos. v. Care Corp.*,¹³⁸ which also involved defensive measures by target management. The Second Circuit, after noting that the "starting point in our analysis is the business judgment rule,"¹³⁹ concluded that directors "are called to account for their action only when they are shown to have engaged in self-dealing or fraud, or to have acted in bad faith."¹⁴⁰ The district court's opinion, written after careful scrutiny of the record,¹⁴¹ was thus reversed without any consideration of whether the directors had obtained sufficient information that pointed to the adverse effects of a takeover. In light of the district court's finding that "no good faith effort was ever made by incumbent management of Treadway to determine whether a takeover by Care would or would not be in the best interests of the corporation or its

through divestiture or other alternatives. See Deposition of Edward Blair (Sept. 28, 1978), *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Blair, a director of Marshall Field, gave no consideration to CHH's suggestion that it would sell its overlapping stores. *Id.* (from author's notes of deposition on file at Clerk of Courts Office, N.D. Ill.). CHH advised Blair that the Federal Trade Commission had approved an earlier department store merger involving the largest company in the industry. *See id.* Moreover, management knew that CHH attorneys had concluded that the proposed merger involved no antitrust violations. 486 F. Supp. at 1188. The directors' failure to seek additional information or to explore the alternatives suggested by CHH was excusable if the proposed merger was disadvantageous to Marshall Field, its shareholders, and its employees, but the record shows that no serious analysis was undertaken. Rather, the directors considered this offer to be merely another in a series of takeover threats in which "Fields carefully built its defenses . . . without regard to stockholder interest." 646 F.2d at 306 (Cudahy, J., concurring in part and dissenting in part). The potential advantages of a merger with CHH make the director's neglect even more unjustifiable. See Deposition of Angelo Arena (Oct. 2, 1978), *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Arena, president of Marshall Field, recognized that the "benefit to be accrued [was] pooling of managements and pooling of special professional people in a bigger organization." *Id.* (from author's notes of deposition on file at Clerk of Courts Office, N.D. Ill.).

136. See 646 F.2d at 299-312 (Cudahy, J., concurring in part and dissenting in part). Judge Cudahy began with a careful appraisal of the business judgment rule. He then embarked on a thorough review of the directors' actions in both historical and current contexts and made frequent references to the record and to exhibits. Because the defendants received a directed verdict, Judge Cudahy argued that the evidence presented questions of fact that should have been considered by a jury. See *id.* at 312.

137. *Id.* at 306.

138. 638 F.2d 357 (2d Cir. 1980).

139. *Id.* at 381.

140. *Id.* at 382.

141. See 490 F. Supp. 668, 670-82 (S.D.N.Y.), *rev'd*, 638 F.2d 357 (2d Cir. 1980).

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shareholders,"¹⁴² the appellate court's use of the business judgment rule to reverse the district court reflects either a misunderstanding of the duty of reasonable care or a rejection sub silentio of a reasonable care standard.¹⁴³ In sum, the fundamental error in *Shlensky, Panter, Treadway*, and similar cases that invoke the business judgment rule is the substitution of motives for diligence. By regarding the business judgment rule as the primary issue and defining it narrowly in terms of self-dealing, fraud, or bad faith, courts thereby ignore the basic premise of the rule.¹⁴⁴

In contrast to the approach of the aforementioned cases, but equally troublesome, is the court's approach to director diligence in *Gimbel v. Signal Cos.*¹⁴⁵ Even though the *Gimbel* court recognized the appropriate scope of inquiry when the diligence of directors is in question, it retreated into the shelter of the business judgment rule to evade the dictates of a reasonable care standard. The plaintiff in *Gimbel* brought suit as a shareholder to enjoin a pending sale of a Signal Oil subsidiary to Burmah Oil for \$480,000,000. The subsidiary represented approximately 26% of Signal's total assets and approximately 15% of its earnings.¹⁴⁶ Plaintiff alleged that the sale price was inadequate and raised the issues of valuation and the directors' care in examining the transaction.¹⁴⁷ Although the directors had discussed a number of issues relevant to the transaction at the board meeting, they had not been provided with any written data on most issues.¹⁴⁸ After approximately two hours of consideration, the board approved "possibly one of the

142. *Id.* at 686 (citation omitted).

143. "In applying the business judgment rule to the actions of Treadway's board, the Second Circuit failed to inquire into the *sufficiency* of the board's consideration of the relative merits of the alternative Care and Fair Lanes combination." Note, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 Nw. U.L. REV. 980, 989 (1982) (emphasis in original).

144. Espousal of the business judgment presumption by federal courts may be contrary to the underlying state standards purportedly being applied. The dissenting opinions in both *Panter v. Marshall Field*, 646 F.2d at 299 (Cudahy, J., concurring in part and dissenting in part), and *Johnson v. Trueblood*, 629 F.2d 287, 295 (3d Cir. 1980) (Rosenn, J., concurring in part and dissenting in part), *cert. denied*, 450 U.S. 999 (1981), criticize the majority opinions for failure to adhere to Delaware state law, which would impose the burden of proof on the defendant directors to justify their actions as primarily in the corporation's best interests.

145. 316 A.2d 599 (Del. Ch.), *aff'd per curiam*, 316 A.2d 619 (Del. 1974).

146. *See id.* at 607.

147. On the issue concerning the adequacy of the directors' examination of the transaction, the record revealed: (1) Burmah's offer was transmitted on December 18, 1973, and required an acceptance within 72 hours; (2) the directors' meeting was held on December 21; (3) outside directors were not notified of the meeting's purpose, and three of them learned of the offer for the first time at the meeting; (4) the directors received only a handwritten outline of the transaction and an oral presentation; and (5) the current oil and gas reserves of Signal Oil were not presented to the board. *See id.* at 612.

148. *Id.* at 612-13.

largest private cash sales ever to take place."¹⁴⁹

In its opinion, the court recognized the failings of management. For example, following its recitation of the limited time and information available to the board in light of the significance of the transaction, the court criticized Signal's management for its failure to make an "advance effort to educate the directors whose responsibility it was to approve the transaction,"¹⁵⁰ given that management had decided months before the meeting to recommend Burmah's offer to the board. The court also criticized management for making no effort to seek an extension of the period demanded by Burmah for acceptance of its offer.¹⁵¹

In light of its criticisms of management, the *Gimbel* court should have had little difficulty granting the requested injunction. Nevertheless, with a complete change of tone, the court held that the conduct surrounding the transaction was sufficient only to "suggest imprudence," but did not rise to a level of misfeasance that would permit the plaintiff "to pierce" the business judgment rule.¹⁵² Thus, with remarkable ease, the court retreated from its earlier demand that "informed directors . . . make a business judgment"¹⁵³ to a standard which accepts imprudence, neglect, and haste. Perhaps the retreat to this lenient standard was due to the impressive size of the transaction or the court's reluctance to enjoin a transaction that could have been beneficial to the corporation. In fact, the court expressed these sentiments when it entered a preliminary injunction based upon substantial discrepancies in the testimony given on valuation.¹⁵⁴ Or, perhaps the court's lax approach to the issue of diligence reflects its choice to protect the shareholders' interest, at least to the extent of the price of shares, through valuation. Although such explanations might vitiate criticism of the court, *Gimbel* remains a prime example of judicial retreat to the business judgment rule by a court that had recognized the appropriate

149. *Id.* at 612.

150. *Id.* at 614.

151. *See id.*

152. [These factors] do not . . . raise . . . a reasonable probability that the plaintiff will be able to pierce the "business judgment" standard. When considered in light of the whole case, they do not in themselves justify the conclusion that the "directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment."

Id. at 615 (quoting *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 330, 167 A. 831, 833 (1933)).

153. 316 A.2d at 609.

154. *See id.* at 618. The judge noted that "[t]he situation is not to my liking," *id.* at 617, and declared his intention "[not] to allow a preliminary injunction to destroy the Corporation's opportunity for this transaction." *Id.* at 618. Shortly after the preliminary injunction was ordered, the case was settled and Signal Oil was sold. Telephone interview with Allen M. Terrell, Jr., Richards, Layton & Finger, plaintiff's counsel (Aug. 4, 1983).

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scope of the inquiry into the diligence of directors and had come to the verge of applying a reasonable care standard.

The judicial reluctance to inquire into the adequacy of the information available to directors and of the decisionmaking processes of directors is unfortunate because a duty of reasonable inquiry *is* recognized at common law.¹⁵⁵ In *Kaplan v. Centrex Corp.*,¹⁵⁶ a shareholder filed a derivative action claiming that the corporation had accepted inadequate consideration in exchange for corporate property. The court rejected the defendant directors' invitation to invoke the business judgment rule because the directors failed to show that they had made an informed business decision.¹⁵⁷ Although the court imposed liability for one of the two corporate transactions that were challenged,¹⁵⁸ it did not require that the directors' conduct meet an unrealistic standard of diligence, nor did it ignore the constraints that directors face. Rather, the court required only that defendants "show that director judgment was brought to bear with specificity on the transactions."¹⁵⁹ Even this lenient standard seems sufficient to support relief in cases such as *Shlensky*, in which the directors sought no information to corroborate Philip Wrigley's personal beliefs about neighborhood deterioration,¹⁶⁰ *Panter*, in which the directors considered no alternatives to thwarting the hostile takeover,¹⁶¹ and possibly *Gimbel*, in which directors, on the basis of a handwritten outline and a brief oral discussion, approved a \$480,000,000 transaction.¹⁶² The imposition of a duty on directors to obtain adequate information by way of reasonable inquiry requires only minimal judicial scrutiny of the decisionmaking processes of directors. Yet, such minimal scrutiny would ensure that a business judgment had been made before defendants could invoke the business

155. Only one jurisdiction has codified a duty of reasonable inquiry. See CAL. CORP. CODE § 309(a) (West 1977) (directors are to act "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would under similar circumstances").

156. 284 A.2d 119 (Del. Ch. 1971).

157. Application of the rule, of necessity, depends upon a showing that informed directors did, in fact, make a business judgment authorizing the transaction under review. And, as plaintiff argues, the difficulty here is that evidence does not show that this was done. There were director-committee-officer references to the realignment but none of these, singly or cumulatively, show that director judgment was brought to bear with specificity on the transactions.

Id. at 124.

158. See *id.* at 127, 129.

159. *Id.* at 124.

160. See *supra* text accompanying notes 119-26; see also *Lutz v. Boas*, 39 Del. Ch. 585, 609, 171 A.2d 381, 395-96 (1961) (outside directors of investment fund who "did not discuss securities at their meeting . . . or any of the other facts which would have been pertinent to a reasonable discharge of their duties" found liable for improper fund expenses).

161. See *supra* text accompanying notes 127-37.

162. See *supra* text accompanying notes 145-54.

judgment rule.¹⁶³

(b) *Consistency between factual investigations and directors' decisions.*—If directors' conduct is to be subject to a realistic standard of reasonable care, directors must be required to do more than merely engage in reasonable steps in order to acquire adequate information. "Deliberative decisionmaking" means not only that adequate information has been obtained but also that it has been used in some rational manner by the decisionmaker to reach a conclusion. Yet, the difficulty that faces any judicial inquiry into the way in which directors have used relevant information is that rigorous scrutiny places a court in the position of second-guessing the business judgment of directors, while lenient scrutiny may allow the "common culture" of the boardroom, which dictates deference to the chief executive officer,¹⁶⁴ to thrive. Although the line between examining the process and the substance of decisionmaking is difficult to draw, judicial scrutiny of director diligence would be meaningless if it were to examine pro forma process, but did not consider whether the action of the board could be supported by the factual record.

In *Auerbach v. Bennett*,¹⁶⁵ the New York Court of Appeals wrestled with the delicate distinction between judicial review of process and judicial review of substance. In evaluating the recommendation of the corporation's committee of disinterested directors that the suit be dismissed, the court sought to limit its inquiry to the procedures employed by the committee, since the committee's substantive decision was purportedly beyond the scope of judicial review.¹⁶⁶ Despite this professed

163. There is little mystery in determining minimum standards of investigation and consideration. For example, leading counsel have published checklists of inquiry for directors faced with tender offers. See Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 121-24 (1979). Despite such readily available guidance, none of the courts dealing with defensive takeover measures has attempted to compare the record with such standards. Failure to demand diligent decisionmaking by target management renders hollow not only the "due care" provisions of state law but also the SEC's attempt through rule 14e-2, 17 C.F.R. § 240.14e-2 (1983), to require reasoned statements supporting management's recommended acceptance or rejection of the pending tender offer.

164. See Brudney, *supra* note 3, at 612-13; Coffee & Schwartz, *supra* note 4, at 283-84 & nn.124-27; Note, *supra* note 3, at 1898-1901.

165. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

166. [T]he action of the special litigation committee [had] two components. First, there was the selection of procedures appropriate to the pursuit of its charge, and second, there was the ultimate substantive decision The latter, substantive decision falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. To this extent the conclusion reached by the Committee is outside the scope of our review To permit judicial probing of such issues would be to emasculate the business judgment doctrine

Id. at 633-34, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. *Contra* Joy v. North, 692 F.2d 880, 891

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limitation, the court recognized that judicial examination of process alone is inadequate when formal procedures disguise decisions that have otherwise been determined, and it guardedly admitted that, under these circumstances, inquiry into the decision of directors is necessary.¹⁶⁷

Although the court concluded, after a brief review of the process employed by the litigation committee, that the record showed no "insufficiency or infirmity as to the procedures or methodologies chosen . . . by the special litigation committee" and raised no "triable issue of fact as to the good-faith pursuit of [the committee's] examination,"¹⁶⁸ it is doubtful that the court in fact examined "good-faith pursuit" as an independent question. Such an examination would have involved a judicial determination, not found in the court's opinion, that the committee's decision was rationally consistent with the results of its investigation. Inevitably, judicial inquiry into the consistency of the directors' investigation and their decision is a necessary condition for a judicial determination that the investigation was pursued in good faith. Yet, contrary to the admonition expressed in *Auerbach*, analysis of the committee's decision would not be equivalent to the court's exercise of a substituted business judgment. The review could be narrowly confined, and the standard of review, not unlike that accorded to administrative agencies under federal statute, would require the reviewing court to set aside actions and findings "unsupported by substantial evidence."¹⁶⁹ Judicial deference in administrative law, as in corporate law, is based upon the presumed expertise and efficiency of the fact-finder and shows respect for the fact-finder's decision, unless the record "clearly precludes" justification for the decision.¹⁷⁰ Consistent with this approach, the committee's decision in *Auerbach* would be beyond judicial reproach if it had any significant support in the record. The

(2d Cir. 1982) (finding that *Auerbach* "gives excessive weight to the recommendations of special litigation committees"), *cert. denied*, 103 S. Ct. 1498 (1983); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981) (court exercises its independent business judgment to determine whether special litigation committee may dismiss suit).

167. Proof, however, that the investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or half hearted as to constitute a pretext or sham, consistent with the principles underlying the application of the business judgment doctrine, would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine.

Id. at 634-35, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929.

168. *Id.* at 636, 393 N.E.2d at 1003, 419 N.Y.S.2d at 930.

169. 5 U.S.C. § 706(2)(E) (1982).

170. *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 490 (1951) (Frankfurter, J.) ("The Board's findings are entitled to respect; but they must nonetheless be set aside when *the record* . . . clearly precludes the Board's decision from being justified by a fair estimate of the worth of the testimony of witnesses or its informed judgment on matters within its special competence or both.") (emphasis added).

analogy to agency review suggests that directors' decisions would be upheld by "something less than the weight of the evidence."¹⁷¹ Moreover, directors' decisions would be defensible even if, in hindsight, they were erroneous, unwise, or contrary to the decisions other reasonable directors might have made, since "the possibility of drawing two inconsistent conclusions from the evidence does not prevent . . . findings from being supported by substantial evidence."¹⁷²

The foregoing analysis differs from the Tentative ALI Draft,¹⁷³ which proposes a two-stage judicial inquiry—one stage restricted to due care and the other to the protective insulation of a business judgment rule.¹⁷⁴ The Draft codifies the business judgment rule as a backstop against liability even when statutory duty of care standards have not been met. Because of the "desire to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions,"¹⁷⁵ the Draft would apply the business judgment rule to shield directors even in the face of a judicial finding of lack of care if their decisions were: (1) informed and made on the basis of reasonable inquiry; (2) made in good faith and without a disabling conflict of interest; and (3) made on a rational basis.¹⁷⁶

In seeking clarity by separating reasonable care from business judgment concerns, the Draft instead only creates further confusion. The Draft, unlike any statute or decision to date, suggests that breach of the duty of care is not actionable unless, on the basis of an independent inquiry, the business judgment rule is also found to be inapplicable.¹⁷⁷ Given this approach, the due care and business judgment standards of the Draft are functionally equivalent, except for the "rational basis" element of the latter. The Draft apparently envisions a scenario in which a court finds that "reasonably prudent directors would have reached a contrary decision"¹⁷⁸ (thus, a lack of due care), but applies the business judgment rule because the challenged decision had a "rational basis" (*i.e.*, it was honest, informed, and "not egregiously unreasonable").¹⁷⁹ The error of the Draft, however, is its conclusion that due care and diligence have not been exercised if reasonably prudent directors would have reached a decision contrary to

171. *Consolo v. Federal Maritime Comm'n*, 383 U.S. 607, 620 (1966).

172. *Id.*

173. See CORPORATE GOVERNANCE, *supra* note 2, at 140-214.

174. *See id.* at 211.

175. *Id.* at 143.

176. *See id.* at 144.

177. *See id.* at 211.

178. *Id.* at 143.

179. *Id.* at 144.

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the actual decision in question. The duty of care should not require that a business judgment necessarily conform to that of hypothetical directors but rather should ensure that the directors' actual decision was the result, right or wrong, of a deliberative decisionmaking process.¹⁸⁰ That other reasonable directors would have reached a different conclusion is not only immaterial, but also is a standard that involves the courts in second-guessing the merits of directors' decisions. The appropriate judicial inquiry, therefore, is not how other reasonably prudent directors might have reacted, but whether the decision of the defendant directors is supported by a significant portion of the information available to them.¹⁸¹

Finally, statutory and common-law formulations often include the element of "good faith,"¹⁸² which has caused courts on occasion to regard motives rather than process as the primary area of inquiry. Reasonable care is met, however, not by actions in "good faith," but rather by actions consistent with obligations of diligent inquiry and decision-making. The requirement of "good faith" is superfluous if satisfied by process and, conversely, undercuts the standard of care if it causes courts to focus primarily on motives. An inquiry into "good faith" independent of process, which would examine external factors such as potential conflict of interest or the influence of third parties,¹⁸³ is appropriate if such matters are not reflected in a review of process—particularly if the decision has sufficient, even if not preponderant, support in the factual record and thereby satisfies due care standards of deliberation.

IV. The Problem of Sanctions

Remolding duty of care expectations and untangling the standard from the business judgment rule will not cause a marked change in judicial attitude in the absence of some limitation on personal liability.

180. See *supra* notes 108-11.

181. See, e.g., *Selheimer v. Manganese Corp. of Am.*, 423 Pa. 563, 584, 224 A.2d 634, 646 (1966) (based on the information available to the directors, their decision to continue operations at an unprofitable plant "defies explanation").

182. See *supra* note 7.

183. See, e.g., *Royal Indus. v. Monogram Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,131 (C.D. Cal. Nov. 29, 1976). The court dismissed Royal's claim of good faith as follows:

Royal purported to undertake to conduct an investigation of Sar in connection with its acquisition, but the obvious purpose of that investigation was not to determine whether Sar would be a good acquisition for Royal, but to establish a record and to create an illusion of due diligence. The only motivation behind the acquisition of Sar was to seek to thwart the Monogram Tender Offer.

Id. at 91,135.

Judicial concern over substantial damages lay behind the admonition that ordinary standards of negligence would make it "almost impossible to secure the services of able and experienced corporate directors."¹⁸⁴ In securities litigation, similar judicial concerns have led courts in rule 10b-5 actions to narrow standards, restrict the class of plaintiffs, and limit the bases for awarding damages.¹⁸⁵ The concern is natural, for neither a negligence nor a 10b-5 action against directors necessarily involves self-enriching defendants. In the absence of a finding of personal profit, courts may be understandably reluctant to impose catastrophic consequences for a single act of neglect by a well-meaning director.¹⁸⁶ This judicial attitude is reinforced by the recognized dependency of directors on management and the accepted role of the corporation as a risk-taking venture.¹⁸⁷

The imposition of damages on corporate directors is not readily analogous to the imposition of damages on ordinary tortfeasors. Directors are seldom the primary actors in the corporate setting, their conduct usually results from their reliance on management or third parties for information, and, assuming good faith, they do not act to gain personal economic benefit. Although these factors do not excuse a lack of care, each raises a question of mitigation. Moreover, judicial reluctance

184. *Smith v. Brown-Borhek Co.*, 414 Pa. 325, 333, 200 A.2d 398, 401 (1964) (emphasis omitted).

185. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 216 n.33 (1976) ("Acceptance of respondents' view would extend to new frontiers the 'hazards' of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress."); *Fridrich v. Bradford*, 542 F.2d 307, 320-21 (6th Cir. 1976) (extending the private remedy to the limit of the remedy enjoyed by the SEC would be equivalent to the imposition of punitive damages), *cert. denied*, 429 U.S. 1053 (1977).

186. *See, e.g., Bellis v. Thal*, 373 F. Supp. 120 (E.D. Pa. 1974) (court refused to assess full compensatory liability despite neglect and wilful misconduct), *aff'd mem.*, 510 F.2d 969 (3d Cir. 1975); *Conard, supra* note 21, at 913-15 (damages should be only what a prudent director would risk).

187. *See M. MACE, supra* note 21, at 30-32; *Brudney, supra* note 3, at 633-34; *Note, supra* note 3, at 1898-99. This informational dependence makes it easy for management to get board approval. *See Galfand v. Chestnutt Corp.*, 545 F.2d 807, 810-12 (2d Cir. 1976); *Haft, supra* note 74, at 4; *cf. M. MACE, supra* note 21, at 11-12 (describing the rapidity of board action on management proposals).

The judicial reluctance to impose damages also is reinforced by the general unavailability of indemnification in derivative actions. Delaware, for example, allows indemnification only for a director's expenses and only if the court finds the expenses to be reasonable. *See DEL. CODE ANN.* tit. 8, § 145(b) (1983). In direct actions, indemnification may be available for a loss that results from a judgment or settlement. *See id.* § 145(a); *Conard, supra* note 21, at 899-901 & n.17. Although liability insurance is generally available for losses that result from either direct or derivative actions, *see id.* at 901-03, its scope of coverage, the amount of deductibles, and the limits of insurer liability are factors barred from judicial inquiry. Moreover, when faced not with a historical pattern, but only a single instance of a lapse of due care, courts are understandably reluctant to render decisions that would have adverse impacts on regulation and future insurability. *But cf. MINN. STAT.* § 301.095(7) (1982) (corporations cannot purchase liability insurance for any unindemnifiable act).

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tance to impose damages upon directors varies with the degree of director culpability. Multimillion dollar damage awards are likely when a combination of director neglect and other factors is present,¹⁸⁸ while awards of such magnitude are unlikely when directors at least have attempted to be diligent.¹⁸⁹ Plaintiffs face a difficult burden in this context, for it would be rare for any corporation represented by competent counsel to undertake major action without a modicum of regard for appropriate director consideration, and courts that are aware of the realities of the boardroom, the lack of pecuniary benefit to defendants, and the potential enormity of the damages will seek refuge in the business judgment doctrine.

Judicial reluctance to impose substantial damages against directors also may stem from problems with the element of causation, often an amorphous issue in corporate settings. Few problems arise with a narrow question such as the adequacy of consideration received in the sale of a single piece of corporate property.¹⁹⁰ Far more difficult issues arise for the court and plaintiff when litigation relates to structural decisions, such as mergers and attempted takeovers, or to basic questions of operational policy. For example, in *Bellis v. Thal*¹⁹¹ the court had little difficulty assessing against directors damages ranging from \$5,000 to \$23,000 for corporate waste,¹⁹² and \$24,000 to \$500,000 for self-dealing.¹⁹³ Despite its finding that defendants' actions were "willful and malicious and caused substantial injury to [the parent] and its subsidiary corporations,"¹⁹⁴ however, the court balked at plaintiffs' claim for \$5,000,000, which represented the "shrinkage [of assets] . . . caused by the mismanagement."¹⁹⁵ The court summarily noted that plaintiffs had

188. For example, in *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981), the court assessed damages of \$10,000,000 against the defendant director. The director had neglected her duties and could have easily discovered the misappropriation of funds. *See id.* at 38-39, 432 A.2d at 825-26. Moreover, the court found that the director was in a position similar to a bank director because of the nature of the corporation's business and treated the case accordingly. *See id.* at 38, 432 A.2d at 825 ("As a reinsurance broker, . . . it resembled a bank rather than a small family business.").

189. Three of the six cases that have found liability for negligent mismanagement, *see* cases cited *supra* note 2, did not assess damages, but were returned to the trial court. *See* *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397, 107 N.Y.S.2d 1004 (1953); *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966); *Clayton v. Farish*, 191 Misc. 136, 73 N.Y.S.2d 727 (Sup. Ct. 1947). Of the three cases that awarded damages, the highest award was only \$547,021, and that award was subject to contribution among the sixteen defendant directors. *See* *Heit v. Bixby*, 276 F. Supp. 217, 236-37 (E.D. Mo. 1967).

190. *See, e.g., Kaplan v. Centex Corp.*, 284 A.2d 119, 130 (Del. Ch. 1971).

191. 373 F. Supp. 120 (E.D. Pa. 1974), *aff'd mem.*, 510 F.2d 969 (3d Cir. 1975).

192. *Id.* at 132-33.

193. *Id.* at 125-32.

194. *Id.* at 133.

195. *Id.*

failed to meet their burden of proving that the directors' conduct had caused "the entire amount of [the corporation's] loss."¹⁹⁶ A similar concern with the amorphous issue of causation in the corporate setting prompted Judge Learned Hand's rhetorical query in *Barnes v. Andrews*: "How can I, sitting here, lay it down that Andrews' intervention would have brought order out of this chaos, or how can I measure in dollars the losses he would have saved?"¹⁹⁷

Recent litigation concerning director actions to thwart hostile takeovers raises similarly difficult problems for the assessment of damages and the determination of causation. For example, in *Panter v. Marshall Field*,¹⁹⁸ shareholder plaintiffs alleged that "the hasty and ill-considered decision of defendants deprived them of the opportunity to sell their shares at a premium."¹⁹⁹ One plaintiff estimated the aggregate damages suffered by approximately 16,600 shareholders to exceed \$200,000,000.²⁰⁰ Any court prepared to grapple seriously with such a staggering *ad damnum* would have to address at least the following questions: Would Carter Hawley Hale (CHH) have unquestionably gone forward with its proposed merger or tender offer?²⁰¹ If so, what conditions, including shareholder approval, would have been required by the CHH proposal?²⁰² What would have been the likelihood that such conditions would have been met? Would a "lost premium" have been mitigated by a subsequent rise in value of the target stock, or a drop in value of acquirer's stock?²⁰³ If so, what period of time is appropriate for study? To raise the foregoing questions is to indicate the

196. *Id.*

197. 298 F. 614, 618 (S.D.N.Y. 1924).

198. 486 F. Supp. 1168 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

199. *Id.* at 1192.

200. *Id.* at 1173.

201. CHH's proposed offer was for \$42 per share in cash and stock. *Id.* The offer could be transmitted only after the SEC reviewed and approved the registration statement that covered the proposed exchange. *Id.* at 1183. While the SEC review was pending, CHH was under no obligation to proceed and could choose, as it did, to terminate its efforts for any reason, including market factors, competing bids, or changed circumstances of any nature. *See id.* at 1190-91. At no time from the commencement of its proposed offer in October 1977 to its withdrawal the following February was CHH bound to any course of action. *See id.*

202. CHH's proposed exchange offer was conditioned on the fulfillment or nonoccurrence of approximately 13 conditions. *Id.* at 1191. The conditions included the approval by shareholders of CHH capital stock and an option granted to CHH to withdraw if more than 5% of the shareholders of CHH common stock invoked their dissenters' rights. *Id.* at 1183.

203. A study of 36 unsolicited tender offers defeated by target management from 1973 to 1979 concluded that "the shareholders of more than 50 percent of the targets are better off today than if the defeated tender offer had succeeded." Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 107 (1979). When the offer is an exchange offer of stock for stock, like the CHH offer, market forces make comparative valuations difficult, which in turn makes it difficult to assess damages. *See* 486 F. Supp. at 1173.

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wholly speculative nature of assessing damages in *Panter*-type litigation.²⁰⁴

Because the common-law concept of damages is based upon principles of compensation rather than deterrence,²⁰⁵ courts are prevented from awarding less than the full measure of loss. The hardship of the defendant or respect for the difficulty of his role as director cannot properly be calculated into the damage formula.²⁰⁶ The theoretical construct of compensatory damages, therefore, is a significant impediment to shareholders' actions at law. As a reform measure, the ALI's Tentative Draft on Corporate Governance²⁰⁷ proposes monetary ceilings on director liability for due care violations, which range from a maximum of \$200,000 for outside directors to the greater of that amount or twice the gross compensation for inside directors.²⁰⁸ The Draft adopts the premise that deterrence rather than compensation is the appropriate goal of damages in derivative actions²⁰⁹ but assumes that movement away from common-law traditions of compensation requires legislative action.²¹⁰ Given the much heralded "race to the bottom"²¹¹ among state corporate codes, it is implausible to expect state legislatures to adopt a measure of liability that increases the chances of successful shareholder litigation against directors. The modification of director obligations²¹² and the imposition of procedural hurdles for derivative actions²¹³ indicate that the trend is to the contrary. The Draft, however, suggests several reasons that corporate management might favor such legislation. For example, it might mitigate independent di-

204. Causation and measurement problems may be equally difficult in closed corporations with sharply defined interests. For example, in *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981), shareholders filed a derivative suit which alleged that certain loans and sales of property were tainted with motives to control the corporation. *Id.* at 289 & n.3. The Third Circuit affirmed that causation had not been proved and retreated to the business judgment rule. *See id.* at 292-93.

205. "By the general system of our law, for every invasion of right there is a remedy, and that remedy is *compensation*. This compensation is furnished in the damages which are awarded." *The Steel Trader*, 275 U.S. 388, 391 (1928) (quoting T. SEDGWICK, A TREATISE ON THE MEASURE OF DAMAGES § 29, at 24 (9th ed. 1912)) (emphasis in original); *see also* Conard, *supra* note 21, at 913 ("The difficulty arises from the fact that courts have mechanically applied to directors' liability the classic measure of damages evolved in tort law . . .").

206. *See* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 3.1 (1973). These factors, however, could be considered if punitive damages were at issue. *See id.* § 3.9. Moreover, they would be considered if an equitable remedy were at issue. *See id.* § 2.4.

207. CORPORATE GOVERNANCE, *supra* note 2.

208. *Id.* § 7.06(e), at 380.

209. *Id.* at 232-35. Professor Coffee, one of the reporters for the Tentative Draft, had argued for a deterrence rationale. *See* Coffee & Schwartz, *supra* note 4, at 302.

210. *See* CORPORATE GOVERNANCE, *supra* note 2, § 7.06, at 382.

211. *See* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974).

212. *See supra* notes 80-82 and accompanying text.

213. *See supra* notes 3-5 and accompanying text.

rectors' fears that they will be subject to "the prospect of potentially catastrophic liability,"²¹⁴ it might diminish the bargaining leverage of plaintiffs in nonmeritorious causes, and it might reduce the cost of insurance.²¹⁵ But the current scarcity of successful shareholder actions and the ability of directors to avoid significant liability through settlement render it doubtful, in spite of the Draft's optimism, that management will favor reforms that increase the chances of successful shareholder litigation.

Without legislative reform, remedies that allow courts to avoid the imposition of draconian damages in shareholder litigation are scarce. Remedies at law, based upon the concept of compensation and an all-or-nothing approach, preclude the limitation of damages and cannot accommodate the concerns of plaintiffs and defendants.²¹⁶ Equitable remedies, however, traditionally take the relative hardships of the parties into account²¹⁷ and thus may be able to alleviate the current judicial paralysis in shareholder litigation. As Professor Chayes notes in his examination of public law litigation, the comparative evaluation of competing interests required by equitable remedies often reveals alternatives to a "winner-take-all decision."²¹⁸ The court can fashion remedies to protect, at least partially, the interests of both parties because the "form of relief does not flow ineluctably from the liability determination, but is fashioned ad hoc."²¹⁹

Although cases that fashion relief to accommodate the interests of all parties are more commonly found in such fields as property law,²²⁰

214. CORPORATE GOVERNANCE, *supra* note 2, § 7.06, at 395.

215. *See id.*

216. The judicial power to compromise between the often harsh alternatives of all-or-nothing has received little consideration as a special problem in our jurisprudence. Its neglect is peculiar in light of the high incidence of compromise through private settlement—a procedure of peacemaking in which the judge has taken an increasingly active role as mediator. Judicial activism in chambers is matched only by judicial paralysis on the bench. The "fair" decision promoted in private is one unattainable by law. That which the judge thinks just he cannot order. That which in chambers he calls "unjust" he orders and defends with thirty pages of rhetoric. Strange law? Passing strange I'd say—at least it might seem so to a Lunar visitor who shared our logic but not our legal experience.

Coons, *Approaches to Court Imposed Compromise—The Uses of Doubt and Reason*, 58 Nw. U.L. REV. 750, 751 (1964).

217. *See* D. DOBBS, *supra* note 206, § 2.4.

218. Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1293-94 (1976).

219. *Id.* at 1294.

220. For example, in *Reserve Mining Co. v. EPA*, 514 F.2d 492 (8th Cir. 1975), *modified on other grounds sub nom. Reserve Mining Co. v. Lord*, 529 F.2d 181 (8th Cir. 1976), the Eighth Circuit balanced the interests of a defendant whose plant was discharging effluent into Lake Superior against the interests of the local community. The district court had enjoined the discharge. 380 F. Supp. 11 (D. Minn. 1974). The Eighth Circuit reversed and ordered timetables for the implementation of pollution abatement measures. 514 F.2d at 538-39. The court noted that clo-

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there are corporate cases in which the courts have sought to accommodate the competing interests of the parties involved. In *Mills v. Electric Auto-Lite Co.*,²²¹ for example, one of the remedies sought by the shareholder plaintiffs was judicial dissolution of a merger that had been approved after the circulation of a misleading proxy statement. Having determined liability, the Court noted that the Securities Exchange Act²²² did not require dissolution, but remanded the case to the district court with orders to consider a variety of alternative remedies and to use "the sound discretion which guides the determinations of courts of equity."²²³ The power of the court to tailor remedies in the corporate setting also was addressed in *Rowen v. Le Mars Mutual Insurance Co.*,²²⁴ in which outside directors were found negligent in their failure to inquire into the sale of corporate control. The trial court's order included the dissolution of the acquisition, court appointment of interim directors, and court supervision of the election of a new board.²²⁵ The court rejected defendants' protest that "much of the relief granted is unwarranted and without precedent"²²⁶ on the ground that the broad powers of equity permitted the court to "fashion unusual relief to meet unusual circumstances."²²⁷ The remedies imposed in *Rowen* are similar to the forms of ancillary relief that may be granted in SEC enforcement proceedings.²²⁸ Although this relief is not directly prescribed by

sure of the plant would have a substantial adverse impact on the local economy and sought a remedy that would "serve the ultimate public weal by insuring clean air, clean water, and continued jobs in an industry vital to the nation's welfare." *Id.* at 537; accord *Boomer v. Atlantic Cement Co.*, 26 N.Y.2d 219, 225 & n.*, 257 N.E.2d 870, 873 & n.*, 309 N.Y.S.2d 312, 316 & n.* (1970) (rather than order an injunction, the court recognized a strong local economic interest in an operating plant and ordered a payment to local residents for present and future injury).

221. 396 U.S. 375 (1970).

222. 15 U.S.C. § 78 (1982).

223. 396 U.S. at 386 (quoting *Mcredith v. City of Winter Haven*, 320 U.S. 228, 235 (1943)).

On remand the district court sought to impose damages based on a comparative valuation of the merged companies, but the Seventh Circuit reversed on a finding that the merger terms were fair. See *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir.), cert. denied, 434 U.S. 922 (1977).

224. 282 N.W.2d 639 (Iowa 1979).

225. See *id.* at 656.

226. *Id.*

227. *Id.* at 657.

228. See, e.g., SEC v. Mid Continent Sys., Inc., [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,220, at 92,047 (D.D.C. May 31, 1983) (appointment of an independent audit committee with newly appointed independent director as chairman); SEC v. Catawba Corp., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,331, at 92,047 (D.D.C. Nov. 2, 1981) (special board committees, composed of directors acceptable to the SEC, to investigate and take appropriate action regarding matters in the complaint and to review future transactions in which officers or directors have material interest); SEC v. Consumers Solar Elec. Power Corp., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,984, at 91,063 (D.D.C. May 11, 1981) (retention of attorney experienced in federal securities law to approve all securities offerings and communications with shareholders); SEC v. Mattel, Inc. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807, at 96,689 (D.D.C. Oct. 1, 1974) (appointment of unaffiliated directors, approved by SEC and court, to constitute a majority of the board).

the securities statutes, judicial approval of consent decrees is supported by "the general equitable powers of the federal courts."²²⁹

Equity ought to be the preferred route for shareholder plaintiffs rather than the grand but futile quest for damages of substantial proportions. In actions involving relatively limited recoveries, plaintiffs may be prepared to take their chances in an action at law. Where actions involve potentially substantial damages, it makes much more sense for plaintiffs to temper their insistence on compensatory recovery in favor of equitable relief of more modest and forward-looking proportions.

The framing of equitable relief should be shaped by the nature of the underlying problem.²³⁰ In duty of care cases, if the problem is one of process, the remedy ought to address the abuse of process. Mandatory injunctions could prescribe any one or more of the following remedies: (1) appointment of shareholder representatives to the board; (2) reports by the board to be given directly to shareholder representatives and the court; (3) engagement of special counsel for shareholders at corporate expense to evaluate future structural issues, such as mergers, tender offers, and antitakeover measures; (4) approval by shareholders of actions otherwise within the directors' discretion; (5) greater scrutiny of the boardroom process and input by shareholder representatives through other means, subject to the continuing jurisdiction of the court for a limited period of time.²³¹ The significance of this approach is that the relief granted addresses the underlying causes for the shareholder complaint—lack of alertness to potential corporate

229. See Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1781 (1976). For an early example of judicial recognition of the court's power to mandate and supervise the election of independent directors, see *Orth v. Transit Inv. Corp.*, 132 F.2d 938 (3d Cir. 1942).

230. This leaves this difficult, and in spots the insoluble, problem of designing methods of control which will be both just and fair from the viewpoint of directors and efficient from the viewpoint of investors. In that connection our remedies should not be as hysterical as the practices which made the demand and need for regulation insistent. Prevention will prove more wholesome than punishment. It is a rebuke to our skill and judgment if we cannot effect competent police measures without driving from the field of enterprise the men of greatest competence and substance.

Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1322-23 (1934).

231. The proposed forms of relief, to the extent that they affect the statutory corporate structure, might be challenged as beyond judicial competence. The issue is particularly sensitive when there is multiple litigation that involves actions outside the state of incorporation. The response to this challenge, which requires far greater elaboration than can be accorded here, is based upon two propositions: (1) equity's traditional, undeniable role is to fashion effective relief, see *Rowen v. Le Mars Mut. Ins. Co.*, 282 N.W.2d 639, 656-57 (Iowa 1979); and (2) statutory formalities are intended to facilitate, not shield, effective board action, see, e.g., *Schnell v. Chris-Craft Indus.*, 285 A.2d 437 (Del. 1971) (refusing to validate by-law amendment adopted by the board, even though passed in formal compliance with the state's corporate statute, because of the board's improper purpose to thwart insurgent efforts).

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problems or inadequacy of the directors' decisionmaking process. If plaintiff can prove violations of statutory or common-law standards, equitable injunctive relief should prescribe procedures to reduce the chance of their repetition and to assuage shareholder's concerns of continuing disregard of duty.²³²

The role that such affirmative relief can play to cure abuses of the decisionmaking process is evident when viewed in light of the litigation previously discussed. For example, in *Shlensky v. Wrigley*,²³³ plaintiff sought a judicial order requiring the placement of lights in Wrigley Field. Granting relief might have been far more palatable to the court and consistent with the allegations of director misfeasance²³⁴ had plaintiff instead sought an order requiring directors to consider the issue of night baseball. Injunctive relief could have required a role for shareholder representatives, as well as continuing court supervision of the adequacy of the deliberative process. After an evaluation of relevant data, if the directors concluded that Wrigley's beliefs concerning nighttime baseball games were supported by the factual record, the business judgment rule would appropriately protect the directors against further challenge even if other reasonable directors might have reached a contrary conclusion. Similarly, in the tender offer cases, if shareholders prove inadequate or improper board consideration of pending action, a court could grant injunctive relief to ensure subsequent appropriate board evaluation of relevant aspects of the offer.²³⁵ Although affirmative relief may have only a speculative value after a tender offer has been defeated, as the *Panter*²³⁶ litigation clearly illustrates, the defeat of one offer may be followed by tender offers from other suitors.²³⁷ Even

232. See Coffee & Schwartz, *supra* note 4, at 325 ("[W]e contemplate a form of review that is less substantive and more therapeutic in orientation—one that seeks less to measure the correctness of the result than to inquire, raise alternative possibilities . . .").

Although a director may avoid the personal impact of an injunction by resigning or forgoing reelection, this would not affect the application of the injunction to the corporation and the board. If the injunction applies to the corporation or the board in its corporate capacity, it binds all directors and their successors, provided they have notice of the order. See *Golden State Bottling Co. v. NLRB*, 414 U.S. 168 (1973); *Santiago v. Corporacion de Renovacion Urbana y Vivienda de P.R.*, 554 F.2d 1210 (1st Cir. 1977); see also *FED. R. Civ. P.* 65(d).

233. 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968). For a more complete discussion of *Shlensky*, see *supra* text accompanying notes 119-26.

234. See 95 Ill. App. 2d at 175-77, 237 N.E.2d at 777-78.

235. This remedy, for example, would have been appropriate in *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982), in which the board failed to give adequate consideration to the adverse effects of a defensive tactic during a hostile tender offer. See *supra* note 16.

236. *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

237. See *supra* text accompanying note 134. In 1982, another takeover effort was mounted against Marshall Field & Co. Through open market purchases, an investor group headed by New York investor Carl Icahn acquired approximately 30% of Field's common stock. In order to avoid a shift in control, Field approved a defensive merger with Batus, Inc., a subsidiary of B.A.T.

injunctive relief that only changes board procedures for a limited period of time, therefore, may meaningfully protect the interests of shareholders.

Although injunctive relief may substantially change boardroom procedures, it will not encourage director diligence as effectively as the threat of imposition of damages. Injunction as the sole remedy permits directors a relatively risk-free first bite at the apple of neglect. Some director liability for compensatory damages, therefore, seems necessary to bring about full and effective relief and deterrence. Dual forms of relief are consistent with the historic role of equity to award damages in addition to granting injunctive remedies.²³⁸ Yet, even if damages awarded in equity are less than damages at law, judicial reluctance to impose pecuniary losses on directors remains a problem if no definitive standard is available. A definitive standard is readily available, however, if the calculation of damages is tied to the underlying due care cause of action. Corporate loss would then be measured by the waste of corporate assets arising out of the failure to engage in adequate deliberation, rather than by the gross damages to the corporation alleged in the shareholder's complaint. Thus, expenditures incurred in the decisionmaking process, such as consultants' fees, attorneys' fees, and other direct and indirect costs, could be assessed against directors as truly wasted when their "process" of reaching a decision is a pretext. The costs attributable to the decisionmaking process for major transactions, while usually far less than the damages alleged to have resulted from the board's action, may nevertheless be considerable. A court of equity, viewing the neglect of directors and the particular circumstances of each of the defendants, could appropriately award damages that reflect all or part of such corporate waste.²³⁹

Industries of London and the owner of Gimbel's and Saks Fifth Avenue department stores. *See* N.Y. Times, Mar. 17, 1982, at D1, col. 3. Field reportedly spent \$4,500,000 in defeating the Icahn effort and in arranging the B.A.T. merger. Wall St. J., June 4, 1982, at 18, col. 3. Field's shareholders received \$30 per share in the B.A.T. merger, well under the \$42 per share Carter Hawley Hale sought to offer four years earlier. Wall St. J., Mar. 31, 1982, at 10, col. 1. It is ironic that the Field-B.A.T. merger posed greater antitrust problems than the proposed CHH takeover, although Field's management used antitrust concerns to justify their defense against CHH. *See supra* note 135; *see also* Marshall Field & Co. v. Icahn, 537 F. Supp. 413 (S.D.N.Y. 1982) (Field denied Icahn's claims that contractual arrangements between Field and B.A.T. were manipulative devices in violation of § 14(e) of the Securities Exchange Act, 15 U.S.C. § 78n(e) (1982)).

238. *See* RESTATEMENT (SECOND) OF TORTS § 951 (1976). Power to grant damages in equity was statutorily recognized in Lord Cairns' Act (Chancery Amendment Act), 1857, 21 & 22 Vict., ch. 27. Lord Cairns' Act was eventually repealed as unnecessary by the merger of law and equity in the Statute Law Revision and Civil Procedure Act, 1883, 46 & 47 Vict. ch. 49. *See* Jolowicz, *Damages in Equity—A Study of Lord Cairns' Act*, 34 CAMBRIDGE L.J. 224 (1975).

239. *See, e.g.,* Bellis v. Thal, 373 F. Supp. 120 (E.D. Pa. 1974) (liability imposed for waste due to expenses incurred by director negligence, but not for shrinkage of assets resulting from improper decision), *aff'd mem.*, 510 F.2d 969 (3d Cir. 1975). The proposed measure of liability may

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The proposed combination of injunctive and compensatory relief should not dampen the enthusiasm of plaintiffs' counsel, who are primary actors in both derivative and direct actions.²⁴⁰ Recovery of attorney's fees commensurate with the risk of the undertaking and the overall value of services rendered is not affected by the remedy of injunctive relief. In *Mills v. Electric Auto-Lite Co.*,²⁴¹ the Court recognized that plaintiffs' success in establishing a proxy violation might not result in economic recovery for shareholders and nonetheless supported the award of fees for counsel, stating: "In many suits under § 14(a) . . . it may be impossible to assign monetary value to the benefit. Nevertheless, . . . in vindicating the statutory policy, petitioners have rendered a substantial service to the corporation and its shareholders."²⁴² Because attorneys fees are usually calculated on the basis of such factors as hours worked, probability of success, and quality of representation,²⁴³ there is no policy justification for not awarding equivalent fees when injunctive or compensatory relief is granted.²⁴⁴

Injunctive relief, even when coupled with a limited damage award, is certainly not "complete relief" for shareholders in cases that involve economic loss of major proportions. Yet, perhaps such equitable relief is all that shareholders can realistically expect, since it is not their perspective alone that governs the measure of relief. Public interest, long regarded as an element in the balancing process of equity,²⁴⁵ is a particularly appropriate consideration in cases that concern corporate directorships. Society's interest in encouraging qualified people to accept

result in the curious irony that a court will impose lower damages for waste of corporate assets when directors have engaged in relatively little investigation than when they have taken pronounced steps to involve outside counsel, investment bankers, or others. The paradox is principally theoretical, however, because it is the rare board or corporate counsel that does not seek to create the appearance, if not the reality, of meaningful deliberation through the generation of supposedly disinterested opinions of experts and other outsiders.

If circumstances were to arise in which minimal effort in the decisionmaking process created a de minimis "waste" of assets, the directors' conduct probably would be so egregious that plaintiff's chances of a significant recovery at law would greatly increase. Alternatively, a court of equity might well reach to discover other forms of damage to the corporation (whether related to assets, earnings, market price, or some other measurable factor) on which to base a limited yet significant measure of personal liability.

240. See *supra* note 6.

241. 396 U.S. 375 (1970).

242. *Id.* at 396.

243. See, e.g., *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, 487 F.2d 161, 166-67 (3d Cir. 1973).

244. See, e.g., *Smillie v. Park Chem. Co.*, 710 F.2d 271 (6th Cir. 1983) (plaintiff's attorneys' fees awarded when proxy rules violated but no relief granted).

245. See, e.g., *Virginian Ry. Co. v. System Fed'n No. 40*, 300 U.S. 515, 552 (1936) (public interest in interstate rail activity); *Harrisonville v. W.S. Dickey Clay Mfg. Co.*, 289 U.S. 334, 338 (1932) (public interest in clean sewage facilities); cf. cases cited *supra* note 220 (public economic interest balanced in nuisance cases).

directorships and reasonable risk-taking through corporate ventures weighs against the imposition of harsh penalties for a lapse of care that does not otherwise embrace illegality, fraud, or self-dealing. Complete relief, therefore, must be seen as a function of multiple factors to be weighed in equity.

V. Conclusion

A recent commentator, after reviewing the historically limited role of the business judgment rule, was prompted to ask "why, if the rule was clear in 1829, is it today so frequently misstated by both its detractors and more ardent supporters to suggest that the rule constitutes an impenetrable shield to liability."²⁴⁶ This Article suggests that the dominance of the business judgment rule in due care litigation is the result of a fundamental, unarticulated judicial concern with the ambiguity of standards and the significant gap between the reality of directors' roles and the theoretical construct embedded in statutory obligations. In addition, the rule's dominance stems from an unexpressed reluctance to impose catastrophic damages upon directors who seek neither personal profit nor fraudulent corporate enrichment. Unless director neglect is egregious or provable damages are of manageable proportions, courts are likely to avoid the dictates of a due care standard and take refuge in the business judgment rule. The focus of the shareholder's suit is thereby shifted from the application of standards of neglect to subjective elements of motive or to materially different and burdensome standards of fraud, illegality, or conflict of interest. Unless the dual problems of standards and remedies are addressed, shareholder claims in the duty of care context will effectively linger in the netherworld of settlement negotiations. This Article has proposed a standard of care consistent with minimal expectations of diligence and deliberative decisionmaking. The equitable remedies proposed include injunctive and compensatory relief that will protect the interests of shareholders, ensure minimal diligence and deliberation by directors, and yet not discourage qualified persons from assuming the responsibilities of directorships. The proposals are well within current statutory and judicial norms and should be adopted. Without such reform, shareholder litigation as an element of corporate governance will remain effectively moribund.

246. Arsh, *supra* note 43, at 100.