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THE DUTY OF LOYALTY AND THE EVOLUTION OF THE SCOPE OF JUDICIAL REVIEW

*Dennis J. Block, Michael J. Maimone and Steven B. Ross**

INTRODUCTION

The duty of loyalty—the obligation of corporate fiduciaries to act with disinterested independence and to exercise judgment unaffected by personal financial interest in making business decisions—has existed and has well served and protected equityholders since the inception of the corporate vehicle as an entity used to efficiently aggregate “capital from numerous investors” and operate a “large business with numerous owners and employees.”¹ While the standard by which courts have reviewed claims for breach of this duty has evolved with the advancements in corporate governance, this basic duty owed by fiduciaries to the corporation and its shareholders has remained strong and intact.

Indeed, during the last two decades, with the emphasis on making the corporation more competitive, enormous changes have occurred in the governance of public companies, including changes in the composition of boards of directors (resulting in more independent boards) and the utilization of specialized board committees consisting of independent directors to address conflict-of-interest transactions and related issues. It is with this background and development in the governance of public corporations that courts and legislatures have considered and evaluated issues involving the duty of loyalty. In addressing the duties of corporate fiduciaries, courts and legislatures have recognized that courts should give great deference in reviewing business decisions where the decisionmaker is not

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¹ ROBERT C. CLARK, *CORPORATE LAW* 2 (1986).

tainted by personal financial interest, reserving more demanding judicial scrutiny where such independence is lacking. Thus, in evaluating the current state of the duty of loyalty, the issue is not whether such duty has "declined"—for it has not—but rather the appropriate standard of judicial review to be applied by a court.

The thesis of Professor Joel Seligman, that the duty of loyalty is in decline and in need of help by way of federal regulation, is a romantic notion that finds its roots in the bowels of some past period when corporate governance was in its infancy and has no relationship to the current state of the governance of public corporations. Specifically, Professor Seligman writes in his contribution to this Symposium that "[i]n sum, I believe we have reached a point where Congress should consider buttressing the state law duties of loyalty and care with concurrent federal legislation. The appropriate legislation, however, should not fully preempt state law and should be no broader than its demonstrated need."²

This Article disagrees with Professor Seligman's conclusion that there is a "demonstrated need" for a federal corporate law. Aside from not offering any basis for concluding that "we have reached a point where Congress should consider buttressing" state corporate law, and failing to set forth precisely the scope of such federal regulation, Professor Seligman ignores the significance courts and legislatures place on decisions of disinterested directors³ and the important role such directors play in the governance of modern publicly-held corporations. In sum, Professor Seligman's proposal reflects an approach that was rejected almost twenty years ago⁴ and, with the significant developments in corporate governance over the last two decades, should similarly be rejected today.

In response to Professor Seligman's proposal, this Article surveys the evolving law governing conduct and transactions involving conflicts of interest between the corporation and one or more of its fiduciaries. This survey includes an analysis of

² Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 62-3 (1993).

³ Unless otherwise noted, the term "disinterested director" in this Article refers to an outside, non-management director who is not financially interested in the subject matter of the litigation at issue.

⁴ See generally William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

the scope of judicial review of directorial decisions involving such loyalty concerns (including transactions involving corporate control, derivative litigation against corporate fiduciaries and controlling shareholder transactions), and discusses the two competing standards of review that courts utilize in adjudicating loyalty issues—the business judgment rule and the fairness standard.

I. THE DUTY OF LOYALTY AND THE STANDARDS OF JUDICIAL REVIEW

Corporate directors and officers owe fiduciary duties to the corporations they serve. These fiduciary duties include the duty of care and the duty of loyalty.⁵ “In simplest terms, the duty of care requires that directors exercise the care that an ordinary prudent person would exercise under similar circumstances,⁶ and the duty of loyalty prohibits faithlessness and self-dealing.”⁷ The business judgment rule is a specific application of this directorial standard of conduct. In general terms, under the business judgment rule, courts will not interfere with a business decision if it is made in good faith by disinterested directors after reasonable investigation and does not constitute an abuse of discretion.⁸

Where interested fiduciaries engage in a transaction with the corporation to which they owe a duty, because of the danger such fiduciaries will make business decisions for their personal benefit and to the detriment of the corporation, the fiduciaries are denied the protection of the business judgment rule. Rather, the fiduciaries, absent the utilization of certain safeguards,⁹ have the burden of demonstrating the “fairness” of the transaction in litigation challenging the transaction itself or seeking to impose liability on the fiduciaries.

⁵ See generally DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (3d ed. 1989 & Supp. 1991).

⁶ See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); MODEL BUSINESS CORP. ACT § 8.30 (1991) [hereinafter M.B.C.A.].

⁷ See, e.g., *Norlin Corp.*, 744 F.2d at 264; M.B.C.A. § 8.30.

⁸ See generally BLOCK ET AL., *supra* note 5, at 4-8.

⁹ See generally *infra* notes 145-62 and accompanying text.

A. *The Business Judgment Rule and the Fairness Standard*

Business decisions by corporate directors are ordinarily evaluated by the courts in accordance with the business judgment rule. The courts of Delaware¹⁰ have frequently described the business judgment rule as a "presumption" of regularity—it "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."¹¹ The party challenging the

¹⁰ The authors cite to and discuss primarily Delaware decisional law because, based upon the large number of corporations incorporated in Delaware, Delaware has a sophisticated, well-developed case law with respect to corporate law issues and courts from other jurisdictions give deference to the decisions of Delaware courts. See *Kamen v. Kemper Fin. Serv., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990) (referring to the Delaware courts as "the Mother Court of corporate law"), *rev'd on other grounds*, 111 S. Ct. 1711 (1991); see also *Landy v. Amsterdam*, 815 F.2d 925, 929-30 (3d Cir. 1987) ("[f]inding no Pennsylvania case in point, the district court predicted that Pennsylvania would follow the law of Delaware;" "[w]e agree with the district court"); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986) ("Indiana takes its cues in matters of corporation law from the Delaware courts."); *rev'd on other grounds*, 481 U.S. 69 (1987); *NCR Corp. v. American Tel. & Tel. Co.*, 761 F. Supp. 475, 499 (S.D. Ohio 1991) ("[T]he decisions of Delaware courts are often persuasive in the field of corporate law."); *Weiland v. Illinois Power Co.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,747, at 98,589-90 (C.D. Ill. Sept. 17, 1990) ("Delaware is often recognized as an authority for corporate law."); *Detweiler v. Offenbecher*, 728 F. Supp. 103, 147 n.17 (S.D.N.Y. 1989) ("Michigan courts look to Delaware law as a guide for adjudicating matters involving corporate law."); cf. Leo Herzog & Laura D. Richman, *Foreword to the Second Edition Volume One of R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* at F-1 (2d ed. 1990 & Supp. 1991) (over 40% of the companies listed on the New York Stock Exchange and over 50% of Fortune 500 companies are incorporated in Delaware).

¹¹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). In addition to *Aronson*, since 1984, the Delaware Supreme Court has consistently (fifteen times) defined the business judgment rule, which is typically the governing standard in cases challenging board conduct, as a presumption. See *Stroud v. Grace*, 606 A.2d 75, 83 (Del. 1992); *Kahn v. Sullivan*, 594 A.2d 48, 59 (Del. 1991); *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991); *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1145, 1147 (Del. 1990); *Spiegel v. Buntrock*, 571 A.2d 767, 774 (Del. 1990); *In re Resorts Int'l Shareholders Litig. Appeals*, 570 A.2d 259, 267 (Del. 1990); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989); *Mills Acquis. Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989); *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal Corp. v. Mesa Pe-*

board's decision, therefore, bears the burden of establishing facts rebutting the presumption.¹²

The Delaware Court of Chancery summarized the effect of the business judgment rule and its presumption in *Paramount Communications, Inc. v. Time, Inc.*:¹³

The value of a shareholder's investment, over time, rises or falls chiefly because of the skill, judgment and perhaps luck—for it is present in all human affairs—of the management and directors of the enterprise. When they exercise sound or brilliant judgment, shareholders are likely to profit; when they fail to do so, share values likely will fail to appreciate. In either event, the financial vitality of the corporation and the value of the company's shares is in the hands of the directors and managers of the firm. The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm.

In the decision they have reached here, the Time board may be proven in time to have been brilliantly prescient or dismayingly wrong. In this decision, as in other decisions affecting the financial value of their investment, the shareholders will bear the effects for good or ill. That many, presumably most, shareholders would prefer the board to do otherwise than it has done does not . . . afford a basis to interfere with the effectuation of the board's business judgment.¹⁴

Simply stated, "the business judgment rule operates as a judicial acknowledgement of a board of directors' managerial prerogatives."¹⁵

Where the party challenging a board's decision overcomes this presumption, the business judgment rule will have no applicability and the transaction or conduct at issue will be scrutinized by the court to determine whether it is fair to the corporation.¹⁶ The rationale for this fairness standard "is that

troleum Co., 493 A.2d 946, 954 (Del. 1985); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

¹² See *Spiegel*, 571 A.2d at 774; see also *Short v. McNatt*, No. 10077, 1991 WL 85839, at *4 (Del. Ch. May 20, 1991) (plaintiff bears the burden of "establishing by a preponderance of the evidence that [the business judgment rule is] not present").

¹³ [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

¹⁴ *Id.* at 93,284.

¹⁵ *Spiegel*, 571 A.2d at 774.

¹⁶ See, e.g., *Norlin Corp. v. Rooney*, 744 F.2d 255, 264 (2d Cir. 1984); *Gearhart*

where corporate fiduciaries, because of a conflict, are disabled from safeguarding the interests of the stockholders to whom they owe a duty, the Court will furnish compensatory procedural safeguards by imposing upon the fiduciaries an exacting burden of establishing the utmost propriety and fairness of their actions.¹⁷ As the Delaware Court of Chancery explained in *Cinerama, Inc. v. Technicolor, Inc.*,¹⁸ under the business judgment rule standard of review, "the plaintiff bears the burden to establish each element of the claim he asserts . . . by a preponderance of credible evidence," whereas once the fairness standard is involved, "it is the defendant who is called upon to establish that the transaction attacked was on terms entirely fair to the corporation or, in some circumstances, to the corporation's stockholders."¹⁹

In comparison to the scope of judicial review underlying the business judgment rule, the fairness standard is quite exacting, requiring rigorous judicial scrutiny of the transaction.²⁰ Thus, "because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of [the] litigation."²¹ It is important to note, however, that "the entire fairness rule does not . . . always implicate liability of the conflicted corporate decisionmaker, nor does it necessarily render the decision void."²² Rather, the fairness standard "requires 'judicial scrutiny'" of the transac-

Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 720 (5th Cir. 1984); *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 271 (Del. Ch. 1989); see also *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988) ("Fairness becomes an issue only if the presumption of the business judgment rule is defeated.")

¹⁷ *Van de Walle v. Unimation, Inc.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,834, at 99,030-31 (Del. Ch. Mar. 6, 1991).

¹⁸ No. 8358, 1991 WL 111134 (Del. Ch. June 24, 1991).

¹⁹ *Id.* at *9.

²⁰ See, e.g., *Mills Acquis. Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983); *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58 (Del. 1952).

²¹ *Macmillan*, 559 A.2d at 1279 (quoting *AC Acquis. Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986)); see also *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1123 (Del. Ch. 1990) (the determination that "the propriety of [a] decision is to be measured by the permissive business judgment form of review . . . ordinarily end[s] the matter, practically speaking") (citations omitted).

²² *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993).

tion because "when there is no independent corporate decisionmaker, the court may become the objective arbiter."²³

Indeed, the business judgment rule versus the fairness form of judicial review question "transcends the questions of burden of going forward," because if directors fail to carry their burden under the fairness test "they may be liable not simply to compensate the corporation or its shareholders for losses sustained," but may be required "to rescind the transaction or pay rescissory damages. This measure, while not definitively described, may certainly exceed loss to the corporation and its shareholders and may, analogously to trust measures of recovery, in some instances, capture defendants' profit from the transaction."²⁴ Accordingly, there are "enormous substantive law, not just procedural, consequences to employing the entire fairness form of judicial review."²⁵

B. *Elements of Loyalty*

The protection afforded by the business judgment rule only shields corporate decisionmakers and their decisions from judicial second-guessing where, among other things, the decisionmakers are not subject to disqualifying conflicts of interest with respect to the subject matter of their decision.²⁶ The American Bar Association ("ABA") explained the duty of loyalty in the Model Business Corporation Act ("MBCA")²⁷ as follows:

By assuming his office, the corporate director commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own. The basic principle to be observed is that the director

²³ *Id.*; *cf. id.* at 1376 n.7 (an independent corporation decisionmaker "could be a disinterested and independent majority of the board of directors or the shareholders.") (citing *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976)).

²⁴ *Cinerama, Inc. v. Technicolor, Inc.*, No. 8358, 1991 WL 111134, at *9 (Del. Ch. June 24, 1991) (citing 3 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* § 205, at 241-42 (4th ed. 1988)).

²⁵ *Id.* at *11.

²⁶ *See, e.g., Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); M.B.C.A. § 8.30.

²⁷ The MBCA is a publication prepared by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law (now the Section of Business Law) of the American Bar Association.

should not use his corporate position to make a personal profit or gain other personal advantage.²⁸

As the Delaware Supreme Court recognized in its landmark decision in *Guth v. Loft, Inc.*:²⁹

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.³⁰

Moreover, the "profound knowledge of human characteristics and motives" described above requires "a recognition that where a director . . . stands to benefit personally from the decision as director . . . his . . . business judgment is likely to be affected by personal interest."³¹ Put another way, directors must "possess a disinterested independence and . . . not stand in a dual relation which prevents an unprejudicial exercise of judgment."³² Accordingly, a court's general "unwillingness to assess the merits (or fairness) of business decisions of necessity ends when a transaction is one involving a predominantly interested board with financial interests in the transaction adverse to the corporation."³³ The duty of loyalty is thus

²⁸ ABA Comm. on Corp. Laws, *The Corporate Director's Guidebook* (rev. ed. 1978), 33 BUS. LAW. 1591, 1599 (1978).

²⁹ 5 A.2d 503 (Del. 1939).

³⁰ *Id.* at 510; see also *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939).

³¹ S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 115 (1979).

³² *Auerbach v. Bennett*, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979).

³³ *AC Acquis. Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

transgressed when a corporate fiduciary uses his or her corporate office or, in the case of a controlling shareholder, control over the corporate machinery, to promote, advance or effectuate a transaction between the corporation and such person (or an entity in which the fiduciary has a material economic interest, directly or indirectly) and that transaction is not substantively fair to the corporation.³⁴

The Delaware Supreme Court has recognized that, in satisfying their duty of loyalty, directors must be disinterested and independent.³⁵ In order to demonstrate a lack of "director disinterest," plaintiffs must allege "either a financial interest or entrenchment [motive] on the part of the . . . directors."³⁶ Indeed, where the party challenging a transaction establishes a "material" personal interest or self-dealing by a *majority* of the corporation's directors, the business judgment rule generally has no applicability.³⁷ Allegations that the directors are paid for their services as directors, without more, do not establish a material financial interest.³⁸

The Delaware Court of Chancery defined "material" as "a financial interest that in the circumstances created a reasonable probability that the independence of the judgment of a reasonable person in such circumstances could be affected to the detriment of the shareholders generally."³⁹ The court emphasized that "[i]n some instances an arguable or an established personal financial benefit may, when viewed in context, be found to be immaterial in fact to the exercise of a judgment

³⁴ *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988); cf. *AC Acquis.*, 519 A.2d at 114-15 (finding "a breach of a duty of loyalty, albeit a possibly unintended one," on the ground that the effect of a board's timing of a defensive self-tender offer was to "deprive shareholders of an option that may as likely as not be the more attractive alternative to a majority of them").

³⁵ *Grobow v. Perot*, 539 A.2d 180, 188-89 (Del. 1988).

³⁶ *Id.* at 188.

³⁷ See, e.g., *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 595 n.7 (Del. Ch. 1986); see also *Pogostin v. Rice*, 480 A.2d 619, 626 (Del. 1984) (for the business judgment rule to become inapplicable, "material" interest must afflict a majority of the corporation's directors); *Aronson v. Lewis*, 473 A.2d 805, 815 n.8 (1984) (same).

³⁸ *Grobow*, 539 A.2d at 188-89 (citing *In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986) (construing Delaware law) and *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1074-75 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985)).

³⁹ *Cinerama, Inc. v. Technicolor*, No. 8358, 1991 WL 111134, at *10 (Del. Ch. June 24, 1991).

motivated entirely to achieve the best available result for the corporation and (in the sale context) for its shareholders."⁴⁰ In the court's words:

An example will, I think, demonstrate the point. Consider the case of the sale of a public company which is owned 35% by the CEO and 10% by the company's vice president. The company has a market capitalization of \$100 million. The two officers constitute a majority of the board. Each has a salary and benefit package worth approximately \$550,000 per year. During arm's-length bargaining an acquisition of the corporation is negotiated with a third party for \$160 million cash. As part of the transaction, it is agreed that the two officers will remain as officers of the company at a new higher (say doubled) salary.

Assume now that a shareholder sues the directors claiming that they negligently failed to get the best available price. The directors didn't shop the company, "locked up" the sale, and had no fiduciary out in the merger agreement. Plaintiff also (implausibly) asserts that the directors pushed this transaction rather than search for a higher alternative that might have been found in order to get the higher salaries that the acquiror proposed. Must the directors assume the burden of establishing the entire fairness of the transaction?⁴¹

Applying the materiality standard it had established, the court in *Technicolor* acknowledged that the directors in its hypothetical "do have a financial interest in the merger not shared by the other shareholders," but concluded that the directors would not have a "material" interest in the transaction different from the interest of other shareholders, and that their conduct should therefore be tested pursuant to the business judgment rule.⁴²

In order to demonstrate a lack of "director independence," plaintiffs must allege that a majority of the corporate directors "were dominated or otherwise controlled by an individual or entity interested in the transaction."⁴³ "Control" and "domination" are difficult terms to define precisely, but "at minimum . . . imply (in actual exercise) a direction of corporate conduct in such a way as to comport with the wishes or inter-

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988) (citing *Aronson v. Lewis*, 473 A.2d 805, 815-16 (Del. 1984)).

ests of the corporation (or persons) doing the controlling."⁴⁴ "Control" and "domination" may be the result of either (i) ownership of or the unrestricted power to vote more than fifty percent of the corporation's outstanding voting securities, or (ii) actual control over a majority of the corporation's board of directors or other managing body.⁴⁵

A particularly important case in this regard is *Puma v. Marriott*.⁴⁶ In *Puma*, the Marriott Corporation purchased stock held by entities controlled by the Marriott family, a forty-four percent shareholder controlling four of nine seats on Marriott's board.⁴⁷ On the basis of the process followed by the disinterested directors, the court found that the transaction at issue was not an interested director transaction, and evaluated the transaction pursuant to the business judgment rule:

[P]laintiff here has utterly failed to make any showing of domination of the outside directors. No attempt was made to impugn the integrity or good faith of these directors, all of whom were men of experience in the business and financial world. There is no testimony which even tends to show that the terms of the transaction were dictated by the Marriott Group or any member thereof. On the contrary, the valuations of the property companies and the Marriott stock were made by a majority of Marriott directors, whose independence is unchallenged, based upon appraisal, analysis, information and opinions provided by independent experts, whose qualifications are not questioned. In these circumstances it cannot be said that the Marriott Group stood "on both sides of the transaction" Therefore, the test here applicable is that of business judgment.⁴⁸

Accordingly, "a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation."⁴⁹

⁴⁴ Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971).

⁴⁵ See, e.g., Essex Universal Corp. v. Yates, 305 F.2d 572, 575 (2d Cir. 1962); Gottesman v. General Motors Corp., 279 F. Supp. 361, 384 (S.D.N.Y. 1967).

⁴⁶ 283 A.2d 693 (Del. Ch. 1971).

⁴⁷ *Id.* at 693-96.

⁴⁸ *Id.* at 695.

⁴⁹ *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1332, 1344 (Del. 1987); see also, *Aronson v. Lewis*, 473 A.2d 805, 808-09 (Del. 1985) (court held that directorial independence was present even though it was alleged that the corporation's directors were nominated or elected at the behest of the 47% stockholders); *Siegman v. Tri-Star Pictures, Inc.*, No. 9477, 1989 WL 48746, at *3 (Del. Ch. May 5, 1989) ("For a shareholder to occupy the status of a fiduciary, it must either have majority stock control or exercise actual domination and control over the corporation's business affairs."); *In re Sea-Land Corp. Shareholders Litig.*,

II. INTERESTED DIRECTOR TRANSACTIONS

At common law, interested director transactions were voidable even if such transactions were fair or approved by disinterested directors or shareholders.⁵⁰ This stringent rule applied to individual contracts between the corporation and its directors⁵¹ and interlocking directorates, including where only a minority of the directors were common with respect to the contracting corporations.⁵² Such a rule (treating interested director transactions as voidable without regard to fairness) is arguably equivalent to a rule *per se* prohibiting such transactions in their entirety.

This prohibition against interested director transactions did not survive the test of time. One commentator described the evolution of the law pertaining to interested director transactions, starting in the late nineteenth century through 1960:

a. Prohibition.

In 1880 it could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of

[1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,923, at 90,186 (Del. Ch. May 13, 1988); *In re Sea-Land Corp. Shareholders Litig.*, No. 8453, 1988 WL 49126, at *3 (Del. Ch. May 22, 1987) ("A stockholder is not deemed controlling unless it owns a majority of the stock . . . or has exercised actual domination and control in directing the corporation's business affairs."); *cf.* *Banco De Desarrollo Agropecuario v. Gibbs*, 709 F. Supp. 1302, 1306 (S.D.N.Y. 1989) ("Control persons . . . are those persons who exercise de facto control of the corporation.")

⁵⁰ *See, e.g.*, *Munson v. Syracuse, Geneva & Corning R.R.*, 103 N.Y. 59, 73 (1886) (such a contract "is repugnant to the great rule of law which invalidates all contracts made by a trustee or fiduciary, in which he is personally interested, at the election of the party he represents"); *cf.* *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991) ("At common law, a corporation's stockholders did have the power to nullify an interested [director] transaction, although considerations of the transaction's fairness appear to have played some part in judicial decisions applying this rule."). *But see generally* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DE PAUL L. REV. 655, 659 (1992) ("All current thinking on the corporate director's duty of loyalty appears to start with the proposition, which seems now to be universally accepted, that transactions between a director and his corporation at common law were generally voidable without regard to fairness. It is submitted that this proposition is completely erroneous.") (footnote omitted).

⁵¹ *See, e.g.*, *Wardell v. Union Pac. R.R.*, 103 U.S. 651, 658 (1880).

⁵² *See, e.g.*, *Metropolitan Elevated Ry. v. Manhattan Elevated Ry.*, 11 Daly 373, 491 (N.Y. Com. Pls. 1884).

the transaction.

....

b. Approval by a disinterested majority of the board.

[I]n 1910 . . . the general rule was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged; but that a contract in which a majority of the board was interested was voidable at the instance of the corporation or its shareholders without regard to any question of fairness.

....

c. Judicial review of the fairness of the transaction.

By 1960 . . . the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of the shareholder, whether there was a disinterested majority of the board or not; but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation.⁵³

The elimination of the principle of automatic voidability of conflict-of-interest transactions (including transactions between corporations with one or more common directors) has been codified by many state legislatures in so-called safe-harbor statutes.⁵⁴ These statutes recognize that some interested director transactions "are not inherently detrimental to a corporation."⁵⁵ As the drafters of the MBCA explain:

[T]he essential character of interest conflict is often, unfortunately, misunderstood by the public and the media (and sometimes misunderstood, too, by lawyers and judges). Interest conflicts can and often do lead to baneful acts. The law regulates interest conflict transactions because experience shows that people may be injured. That contingent fear is sufficient reason to warrant caution and to apply special standards and procedures to interest conflict transactions.

⁵³ Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35, 36, 39-40 (1966), quoted in David S. Ruder, *Duty of Loyalty—A Law Professor's Status Report*, 40 *BUS. LAW.* 1383, 1387-88 (1985) and in A.A. Sommer, Jr., *The Duty of Loyalty in the ALI's Corporate Governance Project*, 52 *GEO. WASH. L. REV.* 719, 719-20 (1984).

⁵⁴ See, e.g., CAL. CORP. CODE § 310 (West 1990); DEL. CODE ANN. tit. 8, § 144(a) (1991); N.Y. BUS. CORP. LAW §§ 713(a)-(d) (McKinney 1986); M.B.C.A. §§ 8.60-8.63. Statutes regulating interested director transactions have been enacted in 47 states. Three states—Massachusetts, South Dakota and Utah—and the District of Columbia have not enacted statutory provisions regulating interested director transactions.

⁵⁵ *Oberly v. Kirby*, 592 A.2d 445, 467 (Del. 1991).

Nonetheless, it is important to keep firmly in mind that it is a contingent risk we are dealing with—that an interest conflict is not in itself a crime or a tort or necessarily injurious to others. Contrary to much popular usage, having “conflict of interest” is not something one is “guilty of”; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director’s conflicting interest.⁵⁶

The rationale underlying such statutes appears to be that business judgment rule protection is appropriate for an interested director or officer transaction where “a fully informed majority of disinterested directors properly applies its business judgment in good faith to authorize the transaction.”⁵⁷ Interested director transactions are similarly sanitized where the approval of fully-informed and disinterested shareholders has been secured.⁵⁸ As the Delaware courts have noted, “the entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully informed stockholders.”⁵⁹ During the 1980s, the rationale underlying safe-harbor statutes was applied by courts in addressing loyalty issues that arose in corporate control transactions and in connection with issues of shareholder standing to commence derivative litigation.

⁵⁶ M.B.C.A. §§ 8.60-8.63, at 280-81 (1991) (Intro. Cmt.).

⁵⁷ BALOTTI & FINKELSTEIN, *supra* note 10, § 4.9, at 122; *see also* International Ins. Co. v. Johns, 874 F.2d 1447, 1460-61 (11th Cir. 1989) (construing Florida law; the business judgment rule protects interested director transactions upon a showing of complete disclosure of all material information and approval or ratification by disinterested directors); *Oberly*, 592 A.2d at 467 (“The key to upholding an interested [director] transaction is the approval of some neutral decision making body.”); *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987) (“approval by fully-informed disinterested directors under [Delaware General Corporations Law] section 144(a)(1) . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction”).

⁵⁸ *See* BALOTTI & FINKELSTEIN, *supra* note 10, § 4.9, at 122; *see also Oberly*, 592 A.2d at 467 (“a transaction will be sheltered from shareholders challenge if approved by either a committee of independent directors, the shareholders, or courts”); *Marciano*, 535 A.2d at 405 n.3 (“approval by . . . disinterested stockholders under [Del. Gen. Corp. L.] section 144 (a)(2), permits invocation of the business judgment rules”).

⁵⁹ *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 59, (Del. 1952), *quoted in Smith v. Van Gorkom*, 488 A.2d 858, 890 (Del. 1985).

A. Corporate Control Transactions

The 1980s represented "a decade in which unprecedented merger and acquisition activity raised issues of corporate law that had lain dormant for fifty years."⁶⁰ These issues included the appropriate scope of judicial review to be applied by courts in the context of (i) defensive measures—conduct having the effect of defeating or (arguably) impeding a change in corporate control—adopted by directors, and (ii) interested directors engaged in transactions involving the control of corporations.

In connection with board action in response to an unwanted takeover threat, the Delaware Supreme Court decision in *Unocal Corp. v. Mesa Petroleum Co.*⁶¹ established a standard of judicial review to be applied to defensive measures adopted by directors of Delaware corporations.⁶² In holding that the traditional business judgment rule, in the first instance, is inapplicable to defensive action taken by directors, the supreme court explained that in the control context the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders [gives rise to] an enhanced duty"⁶³ to shareholders that dictates "judicial examination at the threshold before the protections of the business judgment rule may be conferred."⁶⁴ Thus, where directors adopt defensive measures, the court recognized that there exists an inherent conflict of interest with respect to such conduct.

Accordingly, unlike traditional business judgment rule cases where the burden of proof is on the party challenging the transaction, the initial burden in cases involving the adoption of defensive measures lies with the directors, who must demon-

⁶⁰ William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2055 (1990).

⁶¹ 493 A.2d 946 (Del. 1985).

⁶² *Id.* at 954-57.

⁶³ *Id.* at 954.

⁶⁴ *Id.* Subsequent cases reaffirming *Unocal* on this point include: *Stroud v. Grace*, 606 A.2d 75, 82 (Del. 1992); *Gilbert v. El Paso*, 575 A.2d 1131, 1144 (Del. 1990); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1990); *Mills Acquis. Co. v. Macmillan*, 559 A.2d 1261, 1287 (Del. 1988); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1985).

strate (i) that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) that the defensive measures decided upon were "reasonable in relation to the threat posed."⁶⁵ A board undertaking this analysis must evaluate "the nature of the takeover bid and its effect on the corporate enterprise."⁶⁶ This involves consideration of various factors including:

the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of nonconsummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.⁶⁷

The two-pronged *Unocal* burden may be satisfied "by showing good faith and reasonable investigation."⁶⁸ Once this burden is met, traditional business judgment rule principles apply and the plaintiff bears the burden of demonstrating a breach of the directors' fiduciary duties.⁶⁹

The Delaware Supreme Court recognized, however, that the proof presented by the board in support of its initial burden of demonstrating the "reasonableness" of its actions is "materially enhanced" where a majority of the board consists of "outside independent directors."⁷⁰ Likewise, in the context of a board response to an unwanted takeover, several courts outside Delaware have held that the business judgment rule's presumption of good faith is heightened where a majority of the board is composed of independent, outside directors.⁷¹

⁶⁵ *Unocal*, 493 A.2d at 955; see also *Stroud*, 606 A.2d at 82; *Time*, 571 A.2d at 1152; *Macmillan*, 559 A.2d at 1288; *Ivanhoe*, 535 A.2d at 1341; *Revlon*, 506 A.2d at 180; *Moran*, 500 A.2d at 1356.

⁶⁶ *Unocal*, 493 A.2d at 955; see also *Ivanhoe*, 535 A.2d at 1341-42.

⁶⁷ *Macmillan*, 559 A.2d at 1282 n.29; see also *Time*, 571 A.2d at 1153; *Unocal*, 493 A.2d at 955-56 (quoting *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. Ch. 1964)).

⁶⁸ *Unocal*, 493 A.2d at 955; see also *Time*, 571 A.2d at 1152; *Ivanhoe*, 535 A.2d at 1341; *Revlon*, 506 A.2d at 180; *Moran*, 500 A.2d at 1356.

⁶⁹ See *Moran*, 500 A.2d at 1356 (citing *Unocal*, 493 A.2d at 958).

⁷⁰ *Unocal*, 493 A.2d at 955; see also *Ivanhoe*, 535 A.2d at 1343; *Moran*, 500 A.2d at 1350.

⁷¹ See *Panther v. Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Enterra Corp. v. SGS Assoc.*, 600 F. Supp. 678, 685

Similarly, where interested directors are engaged in transactions involving the control of corporations, business judgment rule protection has been secured by the formation of special committees consisting solely of outside directors.⁷² As the Delaware Court of Chancery explained in *Freedman v. Restaurant Associates Industries, Inc.*, “[h]eavy reliance is placed upon the acts of specially constituted committees of disinterested directors when Delaware courts are asked to review the propriety of corporate transactions that involve elements or claims of self-dealing.”⁷³ Similarly, in *In re First Boston, Inc. Shareholders Litigation*,⁷⁴ the chancery court emphasized the role a properly functioning committee of disinterested directors may play in the context of control transactions, and explained that it is “the critical . . . power to say no” that “gives utility to the device of special board committees.”⁷⁵

The power to say no is a significant power. It is the duty of directors serving on such a committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price. Nor is [it] sufficient to get a price that falls within a range of ‘fair values’ somehow defined, if the fiduciary (or another) would pay more. The fiduciary’s best price may not be fair and the fiduciary’s position may preclude the emerge[nce] of alternative transactions at a higher price. The only leverage that a special committee may have where a fiduciary’s position precludes alternatives (such as . . . where a controlling shareholder owns a majority of voting power) is the power to say no and, thus, to force the fiduciary to choose among the options of implementing a frank self-dealing transaction at a price that knowledgeable directors have disapproved, to improve the terms of the transaction or abandon the transaction.

(E.D. Pa. 1985). *But see* *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986) (questioning whether any special weight should be placed upon the fact that a board consists of a majority of outside directors), *rev’d on other grounds*, 481 U.S. 69 (1987); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 266 n.12 (2d Cir. 1984) (same).

⁷² *See, e.g., In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,712-14 (Del. Ch. Jan. 31, 1989).

⁷³ [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,219 (Del. Ch. Oct. 16, 1987).

⁷⁴ [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,322 (Del. Ch. June 7, 1990).

⁷⁵ *Id.* at 96,541.

When independent directors understand the nature of their mission when negotiating a change of control transaction in which management or a controlling shareholder is involved—to agree only to a transaction that is in the best interests of the public shareholders; to say no unless they conclude that they have achieved a fair transaction that is the best transaction available—and where they pursue that goal independently, in good faith and diligently, their decision, in my opinion deserves the respect accorded by the business judgment rule.⁷⁶

The mere existence of a majority of outside directors or a special committee, however, does not insulate a transaction from judicial scrutiny. In *Robert M. Bass Group, Inc. v. Evans*,⁷⁷ for example, the Delaware Court of Chancery afforded no weight to a special committee's approval of a dividend restructuring plan supported by management over an outside bid where the committee did not take "reasonable measures to uncover the facts," but simply "followed in lockstep" management's desire not to investigate or negotiate the outside bidder's offer.⁷⁸

B. *Derivative Litigation*

As in the context of corporate control transactions, courts during the 1980s generally gave great deference to decisions by directors to dismiss or terminate derivative litigation against corporate fiduciaries where the decisionmaker itself was free of any disabling conflict of interest. Indeed, as demonstrated below, even where directors were named as defendants in a derivative litigation, courts permitted the disinterested direc-

⁷⁶ *Id.*; cf. *Kahn v. Lynch Communication Sys., Inc.*, No. 8748, 1993 WL 290193, at *4 (Del. Ch. July 9, 1993) ("[w]hile it would have been far better for the 'unanimous' recommendation of" a special committee, it is sufficient that "a majority of the members . . . concluded that the negotiated price was fair" to the shareholders).

⁷⁷ 552 A.2d 1227 (Del. Ch. 1988).

⁷⁸ *Id.* at 1241; see also *Hanson Trust PLC v. ML SCM Acquis., Inc.*, 781 F.2d 264, 277 (2d Cir. 1984) (The "independent directors" appear "to have failed to ensure that alternative bids were negotiated or scrutinized by those whose only loyalty was to the shareholders."); *Mills Acquis. Co. v. Macmillan*, 559 A.2d 1261, 1280-82 (Del. 1988) (The court afforded no weight to the presence of a majority of outside directors where there was no "broad planning and oversight to insulate the self-interested management from improper access to [a] bidding process," and where "[t]he board was torpid, if not supine, in its efforts to establish a truly independent auction.").

tors to determine whether the litigation against the defendant-directors would be in the best interests of the corporation.⁷⁹

A shareholder derivative action is a lawsuit brought by one or more minority shareholders on behalf of a corporation to remedy an alleged wrong to the corporation "[w]hen the corporate cause of action is for some reason not asserted by the corporation itself."⁸⁰ The action is "two-fold" in nature: "First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it."⁸¹ Accordingly, the lawsuit "[i]n a sense . . . involves a double wrong to the corporation: (a) the basic wrong to it, and (b) its not redressing such wrong directly."⁸²

Prior to filing a derivative action, a shareholder generally must demand that the corporation's board of directors cause the corporation to pursue the alleged claim.⁸³ Courts both in and out of Delaware have repeatedly stated that the demand requirement is not a "mere formalit[y] of litigation"⁸⁴ or a "mere procedural nicety,"⁸⁵ but a "stricture[] of substantive law"⁸⁶ of "critical importance"⁸⁷ that represents "a deliberate departure from the relaxed policy of 'notice' pleading."⁸⁸ The

⁷⁹ See *infra* notes 99-101 and accompanying text.

⁸⁰ HARRY G. HENN & J. ALEXANDER, *LAW OF THE CORPORATION AND OTHER BUSINESS ENTERPRISES* § 360, at 1045 (3d ed. 1983); see also *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 528 (1984) (quoting *Hawes v. Oakland*, 104 U.S. 450, 460 (1881)) (A derivative action is "found on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff."); *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (A derivative action allows a shareholder "to step into the corporation's shoes and to seek in its right the restitution he could not demand on his own.")

⁸¹ *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), quoted in *Kaplan v. Peat Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988).

⁸² HENN & ALEXANDER, *supra* note 80, § 360, at 1045 n.1.

⁸³ See, e.g., *FED. R. CIV. P.* 23.1; *CAL. CORP. CODE* § 800(b)(2) (West 1990); *DEL. CH. CT. R.* 23.1; *N.Y. BUS. CORP. LAW* § 626(c) (McKinney 1986); *M.B.C.A.* § 7.40(b).

⁸⁴ *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1166 (Del. 1989).

⁸⁵ *Richardson v. Graves*, No. 6617, 1983 WL 21109, at *2 (Del. Ch. June 17, 1983).

⁸⁶ *Tandycrafts*, 562 A.2d at 1166; see also, e.g., *In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 (1st Cir.), cert. denied, 414 U.S. 857 (1973); *Cottle v. Hilton Hotels Corp.*, 635 F. Supp. 1094, 1097 (N.D. Ill. 1986).

⁸⁷ *Kaplan v. Peat Marwick, Mitchell & Co.*, 529 A.2d 254, 259 (Del. Ch. 1987), *rev'd on other grounds*, 540 A.2d 726 (Del. 1988).

⁸⁸ *Heit v. Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977); see also *Kauffman*, 479

important "stricture of substantive law" underlying the demand requirement is the "basic principle . . . that directors, rather than shareholders, manage the business and affairs of the corporation The decision to bring a lawsuit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation."⁸⁹ In the words of Dean Robert C. Clark of Harvard University, "[w]hether to sue or not to sue is ordinarily a matter for the business judgment of directors, just as is a decision that the corporation will make bricks instead of bottles."⁹⁰ Thus, where the defendant in a derivative action is a third party (not an officer or director of the corporation), or where only a minority of the directors are alleged to have a financial interest in the conduct or transaction at issue, it is well settled that demand must be made and the board of directors has the power to determine whether to pursue the action; that decision is generally protected by the business judgment rule.⁹¹

Different rules, however, govern the "unusual"⁹² case in which a majority of the directors has a disabling conflict of interest and, thus, where demand is excused. Indeed courts have historically taken the position that where demand on directors is not required because a majority of the corporation's directors are alleged to have breached a fiduciary duty or committed fraud, a shareholder has standing to pursue the corporation's claim to judgment.⁹³ Notwithstanding the historical position taken by courts:

Beginning in the mid-1970's, however, action by disinterested direc-

F.2d at 263; *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1112 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985); *Tabas v. Mullane*, 608 F. Supp. 759, 766 (D.N.J. 1985).

⁸⁹ *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990); *see also, e.g.*, *Kamen v. Kemper Fin. Servs., Inc.*, 111 S. Ct. 1711, 1719 (1991) ("[T]he decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders.") (quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984)); *Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991) ("The directors of a corporation and not its shareholders manage the business and affairs of the corporation, and accordingly, the directors are responsible for deciding whether to engage in derivative litigation.") (citations omitted).

⁹⁰ CLARK, *supra* note 1, at 641.

⁹¹ *See generally* BLOCK ET AL., *supra* note 5, at 492-97.

⁹² M.B.C.A. § 7.44 (Official Cmt. 206).

⁹³ *See, e.g.*, *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917).

tors—typically in the form of a special litigation committee . . . comprised entirely of disinterested directors and vested with full authority to decide whether an action should be continued—has been utilized as a means of terminating derivative litigation naming a majority of a corporation's directors as defendants.⁹⁴

Where the power to terminate exists under applicable state law, the scope of the court's review of a special litigation committee's exercise of that power becomes important. Two competing philosophies have developed. The first, exemplified by *Auerbach v. Bennett*,⁹⁵ adopts the business judgment rule standard of review—disinterested directors, although constituting a minority of the entire board, can and should be trusted to decide whether to pursue derivative claims. Judicial review is therefore limited to the issues of good faith, the independence of the special litigation committee and the sufficiency of the committee's investigation; judicial examination of the merits of the committee's decision is precluded.⁹⁶

The contrary view, exemplified by *Zapata Corp. v. Maldonado*,⁹⁷ leads to the adoption of a more searching judicial review of the merits of a committee's decision. Thus, where demand is excused and the derivative suit has been properly commenced (i.e., a majority of the directors has a disabling conflict of interest), *Zapata* postulates a two-step test for the review of a special litigation committee's determination. This test (i) requires an examination of good faith, the independence of the special litigation committee and the thoroughness of the committee's investigation, and (ii) allows (but does not require) the court to exercise its own "independent business judgment" and review the merits of the committee's decision.⁹⁸ Unlike the *Auerbach* approach—with the directors being afforded the protection of the business judgment rule and its presumption—the *Zapata* approach places all burdens upon the directors.

Regardless of the scope of judicial review, directors serving

⁹⁴ BLOCK ET AL., *supra* note 5, at 497-98; *see also id.* at 498-502.

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

⁹⁶ *Id.* at 636, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930; *see also* Levit v. Rowe, No. 89-7644, 1992 WL 277997, at *4 (E.D. Pa. Sept. 30, 1992) (where "an appropriate special committee" was chosen and "the committee's work was acceptable" a court, under the *Auerbach* approach, "must respect the committee's decision").

⁹⁷ 430 A.2d 779 (Del. 1981).

⁹⁸ *Id.* at 789.

on a special litigation committee must be disinterested in the subject matter of the plaintiff's allegations. Optimally, special litigation committee members should be directors who were not on the board at the time the transaction in question occurred, and who are not defendants in the action.⁹⁹ Frequently, however, plaintiffs trying to foreclose the possibility of a motion to terminate attempt to disqualify all the directors simply by naming them as defendants.¹⁰⁰ A director's status as a "nominal" defendant in and of itself is insufficient to disqualify that director from service on a special litigation committee; "[t]o hold otherwise," as one court recognized, "would allow a small number of shareholders to 'incapacitate an entire board of directors' merely by naming the entire board as defendants."¹⁰¹

More difficult cases involve directors who, while not directly interested in the transaction underlying the litigation, have approved the transaction as members of the board, or have business or social dealings with the corporate officials whose conduct is being challenged. Although the result in any particular case is dependent upon the circumstances surrounding the particular special litigation committee and the particular allegations against the defendant-directors, two lines of cases focusing upon directorial independence in the context of special litigation committees have emerged.

⁹⁹ See, e.g., *id.* at 781; *Auerbach*, 47 N.Y.2d at 625, 393 N.E.2d at 1001, 419 N.Y.S.2d at 928; *Gall v. Exxon Corp.*, 418 F. Supp. 508, 510 n.2 (S.D.N.Y. 1976).

¹⁰⁰ See, e.g., *Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983) (plaintiff's strategy of naming all the directors as defendants is a "transparent litigation tactic . . . like [a] slight of hand that is *slower* than the eye") (emphasis in original), quoted in *Stoner v. Walsh*, 772 F. Supp. 790, 803 (S.D.N.Y. 1991); see also, e.g., *infra* note 103 and accompanying text.

¹⁰¹ See, e.g., *Mills v. Esmark Corp.*, 544 F. Supp. 1275, 1283 (N.D. Ill. 1982) (quoting *Zapata v. Maldonado, Inc.*, 430 A.2d 779, 785 (Del. 1980)). But see N.D. CENT. CODE § 10-19.1-49 (1985) (authorizing creation of a special litigation committee of two or more disinterested directors or other persons, and stating that "a director or other person is 'disinterested' if [he or she] . . . has not been made or threatened to be made a party to the proceeding in question").

1. Majority View: Substantial Disabling Interest Required

A majority of courts that have considered this issue have focused upon whether, considering the totality of the circumstances, the members of the special litigation committee are "in a position to base [their] decision on the merits of the issue rather than . . . extraneous considerations or influences."¹⁰² The courts thus examine the particular facts in each individual case for signs of "interestedness" on the part of each committee member, including—but not limited to—the following:

- Status as a defendant.¹⁰³
- Participation in the alleged wrongdoing.¹⁰⁴
- Nominated to the board of directors by the defendant directors.¹⁰⁵
- Approval of the transaction underlying the alleged wrongdoing.¹⁰⁶
- Presence on the board at the time of the alleged wrongdoing.¹⁰⁷

¹⁰² *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985); *see also Johnson v. Hui*, 811 F. Supp. 479, 486 (N.D. Cal. 1991) ("To determine whether or not the [special litigation committee] has acted independently and in good faith, the Court must review the totality of the circumstances . . .").

¹⁰³ *See Lewis v. Anderson*, 615 F.2d 778, 780 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980); *Johnson*, 811 F. Supp. at 486; *Stoner*, 772 F. Supp. at 802; *Mills*, 544 F. Supp. at 1283-84; *Genzer v. Cunningham*, 498 F. Supp. 682, 693 (E.D. Mich. 1980); *Rosengarten v. International Tel. & Tel. Corp.*, 466 F. Supp. 817, 821 (S.D.N.Y. 1979); *Lewis v. Fuqua*, 502 A.2d 962, 966-67 (Del. Ch. 1985), *appeal denied*, 504 A.2d 571 (Del. 1986); *see also International Broadcasting Corp. v. Turner*, 734 F. Supp. 383, 393 (D. Minn. 1990) (finding interestedness where two members of three member committee were defendants, and the third member of committee was a designee to the board by a third party involved in the alleged wrongdoing).

¹⁰⁴ *See Johnson*, 811 F. Supp. at 486; *Mills*, 544 F. Supp. at 1283-84.

¹⁰⁵ *Weiland v. Illinois Power Co.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,747, at 98,590 (C.D. Ill. Sept. 17, 1990) ("[I]ndependent directors are capable of rendering an unbiased decision though they were appointed by the defendant directors and share a common experience with the defendants.") (citing *Peller v. Southern Co.*, 707 F. Supp. 525, 527 (N.D. Ga. 1988), *aff'd*, 911 F.2d 1532 (11th Cir. 1990)).

¹⁰⁶ *See Mills*, 544 F. Supp. at 1283-84; *Kaplan* 499 A.2d at 1189; *cf. Bach v. National W. Life Ins. Co.*, 810 F.2d 509, 513 (5th Cir. 1987) (vote by special litigation committee members prior to their investigation for a resolution authorizing reimbursement of other directors' interim litigation expenses held not to establish interestedness).

¹⁰⁷ *See Lewis*, 615 F.2d at 780; *Kaplan* 499 A.2d at 1189; *Rosengarten*, 466 F.

- Direct (as opposed to merely indirect) exposure to liability.¹⁰⁸
- Past or present business contracts or dealings with the corporation.¹⁰⁹
- Past or present service to the corporation as, for example, outside counsel or consultant.¹¹⁰
- Business or social ties to one or more of the defendants.¹¹¹
- Nature of the alleged wrongdoing.¹¹²
- Advice of and reliance upon independent counsel of the committee's own choosing.¹¹³
- Number of directors on the special litigation committee (the more directors, the less weight courts seem to assign to a particular disabling interest affecting a single member of the committee).¹¹⁴

Supp. at 821; *Fuqua*, 502 A.2d at 966; *Blecker v. Araskog*, No. 21946-80, slip op. at 38 (Sup. Ct. N.Y. County June 3, 1987).

¹⁰⁸ Compare *In re General Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1083-84 (6th Cir.), cert. denied, 469 U.S. 858 (1984) and *Lewis*, 615 F.2d at 780 with *Abbey v. Control Data Corp.*, 603 F.2d 724, 727 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980) and *Galef v. Alexander*, 615 F.2d 51, 60-61 (2d Cir. 1980).

¹⁰⁹ See *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 378-79 (6th Cir. 1984); *Johnson*, 811 F. Supp. at 486; *Rosengarten v. Buckley*, 623 F. Supp. 1493, 1500-01 (D. Md. 1985); *Kaplan*, 499 A.2d at 1189; see also *Houle v. Low*, 556 N.E.2d 51, 58-59 (Mass. 1990) (finding question of fact regarding interestedness requiring an evidentiary hearing in case where "professional advancement" of only member of committee "appear[ed] to be dependent on the individual defendants").

¹¹⁰ See *General Tire*, 726 F.2d at 1084; *Maldonado v. Flynn*, 485 F. Supp. 274, 283 (S.D.N.Y. 1980), rev'd on other grounds, 671 F.2d 729, 732 (2d Cir. 1982); *Genzer v. Cunningham*, 498 F. Supp. 682, 693-94 (E.D. Mich. 1980).

¹¹¹ See *Hasan*, 729 F.2d at 378-79; *Johnson*, 811 F. Supp. at 486; *Levit v. Rowe*, No. 89-7644, 1992 WL 277997, at *6 (E.D. Pa. Sept. 30, 1992); *Grill v. Hoblitzell*, 771 F. Supp. 709, 712 (D. Md. 1991); *Fuqua*, 502 A.2d at 966-67.

¹¹² See *Fuqua*, 502 A.2d at 972.

¹¹³ See *Peller v. Southern Co.*, 911 F.2d 1532, 1538 (11th Cir. 1990); *In re Oracle Securities Litig.*, No. C-90-0931-VRW, 1993 WL 306658, at *13 (N.D. Cal. Aug. 9, 1993); *Levit*, No. 89-7644, slip op. at 6; *Blecker v. Araskog*, No. 21946-80, slip op. at 38 (N.Y. Sup. Ct. June 3, 1987); cf. *In re Par Pharmaceutical, Inc. Derivative Litig.*, 750 F. Supp. 641, 647 (S.D.N.Y. 1990) (refusing to terminate an action where committee that had recommended termination was not represented by independent counsel).

¹¹⁴ See *Johnson*, 811 F. Supp. at 486; see also *Grafman v. Century Broadcasting Corp.*, 762 F. Supp. 215, 219 (N.D. Ill. 1991) ("[T]his court cannot see any reason why a one man committee cannot be independent, or is any less independent than a two or multiple member committee."); *Fuqua*, 502 A.2d at 967 ("If a single member committee is to be used, the member should, like Caesar's wife, be above reproach."); *Houle v. Low*, 556 N.E.2d 51, 58-59 (Mass. 1990) ("We decline to adopt

Courts typically look to all these factors together and, as a general rule, the only factor that may alone be dispositive against a special litigation committee member is participation in the alleged wrongdoing. Where a special litigation committee did not participate in the alleged wrongdoing, courts typically are reluctant to find that director to be interested,¹¹⁵ and will only do so where a substantial disabling interest can be demonstrated.¹¹⁶ It is important to note that the interestedness determination is made at the time the committee moves to terminate the litigation, and not when the committee is formed.¹¹⁷

2. Minority View: Structural Bias

A second line of cases approaches the issue of assessing director "interestedness" from the perspective that such a determination involves more than merely whether the director is a defendant or participated in the alleged wrongdoing. According to this perspective, personal, family and economic relationships to the defendants, for example, may add a substantial element of bias to an otherwise disinterested director.¹¹⁸

a per se rule that special litigation committees should have more than one director, but we think the number of committee members should be a factor in determining the committee's ability to act independently.").

¹¹⁵ See *In re* General Tire & Rubber Co. Sec. Litig., 726 F.2d 1075, 1083-84, cert denied, 469 U.S. 858 (1984); *Lewis v. Anderson*, 615 F.2d 778, 780 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980); *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1500-01 (D. Md. 1985); *Mills v. Esmark*, 544 F. Supp. 1275, 1281-88 (N.D. Ill. 1982); *Genzer v. Cunningham*, 498 F. Supp. 682, 693-94 (E.D. Mich. 1980); *Kaplan v. Wyatt*, 499 A.2d 1184, 1189-90 (Del. 1985); *Blecker*, slip op. at 36-44.

¹¹⁶ See *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 378-79 (6th Cir. 1984); *Fuqua*, 502 A.2d at 965; see also *Kaplan*, 499 A.2d at 1190 (plaintiff must show that the committee member "based his conclusions . . . on . . . outside influence rather than the merits of the issues").

¹¹⁷ See *Pompeo v. Hefner*, No. 6806, 1983 WL 20284, at *2 (Del. Ch. Mar. 23, 1983) (refusing to consider disinterestedness prior to the committee's completion of its investigation of one member special litigation committee in case challenging conduct of 67 percent shareholder). *But cf.* *International Broadcasting Corp. v. Turner*, 734 F. Supp. 383, 393 (D. Minn. 1970) (denying stay of proceedings pending a determination by special litigation committee because committee was not "sufficiently independent and disinterested . . . to warrant the granting of the requested stay").

¹¹⁸ See generally James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959; George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Liti-*

Some courts have gone even further and have suggested that directors on a special litigation committee instinctively will sympathize with their colleagues on the board, and can be expected to vote for dismissal of any but the most egregious and well-substantiated charges.¹¹⁹ These feelings of sympathy, furthermore, may be reinforced where committee members have been nominated or appointed to their positions by the defendants in the action.¹²⁰

Such logic, upon which Professor Seligman's proposal seems to be based,¹²¹ however, has been the subject of substantial criticism. As correctly recognized in 1989 by Michael P. Dooley of the University of Virginia and E. Norman Veasey of the Delaware Bar (and since 1992, the Chief Justice of the Delaware Supreme Court), but ignored by Professor Seligman, the "structural bias" viewpoint has no logical finishing point, and can be carried to an endless illogical extreme: "If familiarity breeds acquiescence in litigation matters, will it not do so in other contexts as well? If so, does this not suggest a wholesale abandonment of the business judgment rule in favor of judicial review of every board approval of a management proposal that

gation: The Death of the Derivative Suit, 75 NW. U. L. REV. 96 (1980).

¹¹⁹ See, e.g., *Joy v. North*, 692 F.2d 880, 888 (2d Cir. 1982) ("[S]pecial 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."), *cert. denied*, 460 U.S. 1051 (1983). *But see id.* at 900 (Cardamone, J., dissenting) (citation omitted):

When *Burks v. Lasker*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979) was before us we took the same position that the majority now does, i.e., that directors could never be wholly disinterested in deciding whether to pursue claims against fellow directors. On appeal that view was rejected by the Supreme Court which concluded that lack of impartiality of disinterested directors is not a determination to be made as a matter of law.

¹²⁰ See, e.g., *In re Oracle Sec. Litig.*, No. C-90-0931-VRW, 1993 WL 306658, at *13 (N.D. Cal. Aug. 9, 1993) ("'independent' directors are often beholden to the defendant directors who appointed them"); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981) (describing "a 'there but for the grace of God go I' empathy"); *Houle v. Low*, 556 N.E.2d 51, 54-55 (Mass. 1990) (discussing structural bias theory); see also *Lasker v. Burks*, 567 F.2d 1208, 1212 (2d Cir. 1978) ("It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned."), *rev'd*, 441 U.S. 471 (1979).

¹²¹ See Seligman, *supra* note 2, at 5, 24.

turns out badly?"¹²² Indeed, the logic of the "structural bias" viewpoint, taken to its extreme, would preclude in many cases even the creation of a special litigation committee.¹²³

III. THE CONTROLLING SHAREHOLDERS' DUTY OF LOYALTY

Like directors, controlling or dominating shareholders owe fiduciary duties to a corporation's shareholder body as a whole, including minority shareholders.¹²⁴ Unlike directors, however, a controlling shareholder's fiduciary duties arise from the exercise of the controlling shareholder's power. Indeed, in order to have fiduciary obligations a shareholder must "affirmatively undertake[] to dictate the destiny of the corporation."¹²⁵ Although issues involving the controlling shareholder's fiduciary duties are always present whenever a controlling shareholder engages in a transaction with the controlled corporation, such issues are exacerbated in the context of cash-out mergers.¹²⁶

¹²² Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 534-35 (1989); see also *Weiland v. Illinois Power Co.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,747, at 98,590-91 (C.D. Ill. Sept. 17, 1990) ("[S]tructural bias should not destroy the independence of an independent litigation committee, but it should be considered in reviewing the actions and decisions of the independent litigation committee.") (citing *Peller v. Southern Co.*, 707 F. Supp. 525, 527 (N.D. Ga. 1988)); *Aronson v. Lewis*, 473 A.2d 805, 815 n.8 (Del. 1984) (in rejecting the "structural bias" argument, the Delaware Supreme Court noted that "discretionary review by the Court of Chancery of complaints alleging specific facts pointing to bias on a particular board will be sufficient for determining demand futility").

¹²³ See *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983).

¹²⁴ See, e.g., *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Southern Pac. Co. v. Bogert*, 250 U.S. 483, 487-88 (1919); *In re Reading Co.*, 711 F.2d 509, 517 (3d Cir. 1983); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 42-43 (3d Cir. 1947); *Harriman v. E.I. DuPont de Nemours & Co.*, 372 F. Supp. 101, 105-06 (D. Del. 1974). *But see Barris Indus., Inc. v. Bryan*, No. 88-0188-R, slip op. at 5 (E.D. Va. Aug. 15, 1988) ("Controlling shareholders, as such, simply do not owe fiduciary duties to other shareholders.").

¹²⁵ *Harriman*, 372 F. Supp. at 106; see also *Gottesman v. General Motors Corp.*, 279 F. Supp. 361, 383-84 (S.D.N.Y. 1967); *Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am.*, 120 A. 486, 491 (Del. Ch. 1923).

¹²⁶ Outside the context of cash-out mergers, the business judgment rule will protect a parent corporation's conduct with respect to business transactions with a subsidiary where the parent did not cause "the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." *Sinclair Oil Corp. v.*

A. Cash-Out Merger Transactions

Mergers that "by majority rule" force minority interests to give up their equity in a corporation in exchange for cash or senior securities while allowing the controlling shareholder or shareholders to retain their equity have been labeled "cash-out," "freeze-out," "squeeze-out" and "take-out" mergers.¹²⁷ Such transactions may arise in the context of parent-subsidary mergers, "going private" mergers and two-step mergers.¹²⁸ Absent the utilization of certain safeguards,¹²⁹ the danger in such transactions that "a self-interested majority stockholder or control group [will act] unfairly"¹³⁰ to the minority shareholders precludes business judgment rule protection in connection with litigation challenging the transactions themselves or seeking to impose liability on the corporate fiduciary. Rather, the controlling shareholder has the burden of demonstrating the entire fairness of the transaction or securing the informed approval of a majority of either disinterested directors or minority shareholders.¹³¹

The Delaware Supreme Court summarized the necessary showing of fairness that directors must make in these cases in *Weinberger v. UOP, Inc.*¹³² *Weinberger* involved a cash-out merger between UOP, Inc. ("UOP") and its majority owner, The Signal Companies, Inc. ("Signal"). Specifically, two years after Signal acquired its position in UOP at a price of twenty-

Levien, 280 A.2d 717, 720 (Del. 1971), *cert. denied*, 488 U.S. 853 (1988), *quoted in* *Summa Corp. v. TWA, Inc.*, 540 A.2d 403, 407 (Del. 1988).

¹²⁷ See *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 566 n.2, 473 N.E.2d 19, 24 n.2, 483 N.Y.S.2d 667, 672 n.2 (1984).

¹²⁸ *Id.* at 563, 567 n.3, 473 N.E.2d at 22, 24 n.3, 483 N.Y.S.2d at 670, 672 n.3.

¹²⁹ See *infra* notes 145-62 and accompanying text.

¹³⁰ *Alpert*, 63 N.Y.2d at 566 n.2, 473 N.E.2d at 24 n.2, 483 N.Y.S.2d at 672 n.2 (quoting Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1358 (1978)).

¹³¹ See, e.g., *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 846 (Del. 1987); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 & 710-14 (Del. 1983); *American Gen. Corp. v. Texas Air Corp.*, No. 8390, 1987 WL 6337, at *4 (Del. Ch. Feb. 5, 1987); *cf. Abbey v. Montedison S.P.A.*, 143 Misc. 2d 72, 78, 539 N.Y.S.2d 862, 866 (Sup. Ct. N.Y. County 1989) (New York law imposes a duty on a majority shareholder to offer a fair price in the context of a freeze-out merger, but "[i]t is by no means apparent" that such a duty would be imposed in the context of a tender offer by a majority shareholder.).

¹³² 457 A.2d 701 (Del. 1983).

one dollars per share, Signal's management began considering the acquisition of the remainder of UOP's outstanding shares.¹³³ Two Signal directors who were also members of UOP's board utilized UOP information to prepare a feasibility study concerning the proposed acquisition, and concluded that the transaction would be a good investment for Signal at any price up to twenty-four dollars per share.¹³⁴

Signal's senior management then determined to propose a cash-out merger in the range of twenty dollars to twenty-one dollars per share, constituting an almost fifty percent premium over UOP's then market price.¹³⁵ UOP's president—who was also a Signal director and a long-time Signal employee—was told of Signal's plan, and voiced no objection to what he said was a "generous" price.¹³⁶ An investment banking firm was retained and "hurriedly prepared" a fairness opinion concluding that either twenty dollars or twenty-one dollars per share would be a fair price.¹³⁷ Signal's board then authorized a twenty-one dollars per share offer, and UOP's board accepted the proposal.¹³⁸ UOP's shareholders voted to approve the transaction, with almost fifty-two percent of the non-Signal held shares voting in favor of the merger.¹³⁹

In reviewing the transaction, the Delaware Supreme Court held that Signal's conduct did not satisfy the "fair dealing" aspect of the fairness standard.¹⁴⁰ In so holding, the court emphasized:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is

¹³³ *Id.* at 704.

¹³⁴ *Id.* at 705, 709.

¹³⁵ *Id.* at 705, 706.

¹³⁶ *Id.* at 705.

¹³⁷ *Id.* at 706-07.

¹³⁸ *Id.* at 707.

¹³⁹ *Id.* at 708.

¹⁴⁰ *Id.* at 711.

not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.¹⁴¹

The Supreme Court in *Weinberger* remanded the issue of fair price to the Court of Chancery for further consideration and directed that in making this determination all relevant factors were to be considered, including any valuation techniques or methods generally considered acceptable in the financial community.¹⁴² This procedure, the court also directed, was to be applied in the future in appraisal proceedings, which would "ordinarily" constitute the exclusive remedy of dissenting shareholders,¹⁴³ subject to the historic power of the Court of Chancery "to fashion any form of equitable and monetary relief as may be appropriate."¹⁴⁴

¹⁴¹ *Id.* at 711, quoted in *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993); see also *Sealy Mattress Co. of N.J. v. Sealy, Inc.*, 532 A.2d 1324, 1335 (Del. Ch. 1987) ("The majority stockholder [is] obliged not to time or structure the transaction, or to manipulate the corporation's values, so as to permit or facilitate the forced elimination of the minority stockholders at an unfair price."). But see *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.*, 875 F.2d 549 (6th Cir. 1989):

[W]e do not interpret the Maryland test for the fairness of a transaction as one involving separate considerations of both "fair price" and "fair dealing." . . . Maryland law, unlike Delaware law as expressed in *Weinberger*, does not explicitly require consideration of the fairness of the defendants' valuation procedures; and . . . even if Maryland had adopted the *Weinberger* approach, the dominant consideration of the fairness of a transaction remains price.

Id. at 554. See generally ABA Comm. on Corp. Laws, *Guidelines for the Unaffiliated Director of the Controlled Corporation*, 44 BUS. LAW. 211, 217-21 (1988) (suggesting "factors and procedures to be considered by unaffiliated directors when reviewing transactions" between "controlling shareholder[s] and the controlled corporation"); Charles F. Richards, Jr. & Gregory P. Williams, *Rulings of Delaware Courts on Subsidiary Acquisitions*, N.Y. L.J., Oct. 7, 1987, at 31, 35 (reviewing principles that "should substantially increase the likelihood that a transaction will survive the scrutiny of the Delaware courts").

¹⁴² 457 A.2d at 712-14; see also *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1186-87 (Del. 1988).

¹⁴³ *Weinberger*, 457 A.2d at 714; see also *Cede*, 542 A.2d at 1188-90 (holding that fraud action based upon newly discovered facts was not foreclosed by shareholder's earlier election of an appraisal remedy, but that the fraud claim could not be asserted in the appraisal proceeding).

¹⁴⁴ *Weinberger*, 457 A.2d at 714; see also *Cede*, 542 A.2d at 1186-92 (holding that shareholder dissenting from a cash-out merger may pursue both an appraisal remedy and a subsequent individual action for rescissory damages based on a later-discovered claim of fraud in the merger, and that both claims should be consolidated with the shareholder not being required to elect one remedy or the other prior to trial); *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104-

B. *Cash-out Mergers and Disinterested Directors*

The court in *Weinberger* suggested that the result "could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length."¹⁴⁵ The court explained that "fairness in this context can be equated to conduct by a theoretical, wholly independent board of directors," and that "a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness."¹⁴⁶

The court also recognized that the approval of the majority of the corporation's minority shareholders ordinarily shifts the burden of demonstrating unfairness to the plaintiff where the otherwise interested party demonstrates complete disclosure of all material facts relevant to the transaction.¹⁴⁷ The court held, however, that the UOP minority's approval of the transaction was "meaningless" because the minority shareholders were denied "critical information." Thus, based upon the circumstances underlying the shareholder vote—the failure to disclose material information to the minority—the court could not "conclude that the shareholder vote was an informed one."¹⁴⁸

05 (Del. 1985) (noting that remedies other than appraisal are available where appraisal cannot adequately redress the alleged wrong, even under circumstances where there are no allegations of fraud or misrepresentation); *Sealy*, 532 A.2d at 1341 (rejecting argument that "injunctive relief has been judicially eliminated as a remedy in all but the most 'extremely usual' parent-subsidiary merger cases"); cf. *Steinberg v. Amplica*, 729 P.2d 683 (Cal. 1986) (en banc) (appraisal held to constitute exclusive remedy under California law for shareholder alleging that his shares were undervalued because of fraud and breach of fiduciary duty by majority shareholder).

¹⁴⁵ 457 A.2d at 709 n.7.

¹⁴⁶ *Id.* at 710 n.7 (citations omitted); see also *Hanson Trust PLC v. ML SCM Acquis., Inc.*, 781 F.2d 264, 277 (2d Cir. 1986) (noting appropriateness of an "independent negotiating committee of outside directors" in the context of a management leveraged-buyout transaction).

¹⁴⁷ *Weinberger*, 457 A.2d at 703; see also *Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979); *Schlossberg v. First Artists Prod. Co.*, No. CIV. A. 6670, 1986 WL 15143, at *4 (Del. Ch. Dec. 17, 1986).

¹⁴⁸ 457 A.2d at 712. On remand, the Court of Chancery concluded that while "a damage figure cannot be ascertained . . . with any degree of precision," a one dollar per share award would represent a "fair measure of compensation for the wrong done to the members of the minority." *Weinberger v. UOP, Inc.*, No. 5642, 1985 WL 11546, at *9, 10 (Del. Ch. Jan. 30, 1985), *aff'd*, 497 A.2d 792 (Del.

Two years after its decision in *Weinberger*, the Delaware Supreme Court once again emphasized the importance of disinterested directors in *Rabkin v. Philip A. Hunt Chemical Corp.*¹⁴⁹ In *Rabkin*, the supreme court, reversing the court of chancery's grant of a motion to dismiss,¹⁵⁰ acknowledged that in the context of litigation arising from a cash-out merger "the use of an independent negotiating committee of outside directors may have significant advantages to the majority stockholder in defending suits of this type." In the case before it, however, the court recognized that the parent's "alleged attitude toward the minority, at least as it appears on the face of the complaints . . . , coupled with the apparent absence of any meaningful negotiations as to price, all have an air reminiscent of the dealings between Signal and UOP in *Weinberger*."¹⁵¹

Unlike the conduct of the majority shareholder in *Weinberger* and *Rabkin*, *Rosenblatt v. Getty Oil Co.*¹⁵² provides an example of a parent's acquisition of a less than wholly-owned subsidiary that was found to satisfy *Weinberger's* fair dealing/fair price standard. The court emphasized the "adversarial nature of the negotiations" between the parent and the subsidiary, and the absence of any "credible evidence" indicating that the parent had dictated the terms of the transaction.¹⁵³ The court also described the parent's concern about shareholder litigation throughout the negotiations¹⁵⁴ and the questioning of representatives of the parent, two investment banking firms, the subsidiary's own counsel and counsel for a shareholder threatening legal action by the subsidiary's directors.¹⁵⁵ The court also relied upon the committee's lengthy

1985).

¹⁴⁹ 498 A.2d 1099 (Del. 1985).

¹⁵⁰ See *Rabkin v. Philip A. Hunt Chem. Corp.*, 480 A.2d 655, 661 (Del. Ch. 1984), *rev'd*, 498 A.2d 1099 (Del. 1985).

¹⁵¹ *Rabkin*, 498 A.2d at 1106; see also *Sealy Mattress Co. of N.J. v. Sealy, Inc.*, 532 A.2d 1324, 1333-40 (Del. Ch. 1987) (providing what the court characterized as "a textbook study on how one might violate as many fiduciary precepts as possible in the course of a single merger transaction," and granting preliminary injunctive relief); *American Gen. v. Texas Air Corp.*, No. 8390, 1987 WL 6337, at *8 (Del. Ch. Feb. 5, 1987) (denying preliminary injunctive relief but finding reasonable probability of success on claim that merger transaction was structured unfairly).

¹⁵² 493 A.2d 929, 931 (Del. 1985).

¹⁵³ *Id.* at 937.

¹⁵⁴ *Id.* at 934.

¹⁵⁵ *Id.* at 939.

and detailed review of asset values and the fact that there had been asset-by-asset bargaining between the parties to conclude that the price received by the minority shareholders was fair.¹⁵⁶

The Court of Chancery in *In re Trans World Airlines, Inc. Shareholders Litigation* ("TWA")¹⁵⁷ went one step further than the Supreme Court of Delaware with regard to the usefulness of special committees. In *TWA*, the Chancellor stated explicitly that when properly employed, "the device of the special negotiating committee of disinterested directors" has the effect of "making the substantive law aspect of the business judgment rule applicable," and thus places upon the plaintiffs the "particular and . . . particularly difficult" burden of demonstrating that a corporation's merger with a controlling shareholder infringes upon the rights of minority shareholders."¹⁵⁸

In *TWA*, however, the court found that a special committee appointed to represent minority shareholders in connection with a proposed controlling shareholder merger "did not adequately understand its function—to aggressively seek to pro-

¹⁵⁶ *Id.* at 941.

¹⁵⁷ No. 9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988).

¹⁵⁸ *Id.* at *7. *But see* *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 501 (Del. Ch. 1990).

Unlike *TWA* (written by Chancellor William T. Allen), *DuPont* (written by Vice Chancellor William B. Chandler, III) did not extend business judgment rule protection to the underlying transaction. Specifically, the court found that "in a parent-subsidiary merger context, shareholder ratification operates only to shift the burden of persuasion, not to change the substantive standard of review (entire fairness). Nor does the fact that the merger was negotiated by a committee of independent, disinterested directors alter the review standard." *DuPont*, 584 A.2d at 502. According to the court in *DuPont*, shareholder approval or independent negotiations by disinterested directors affords business judgment rule protection only to the subsidiary's directors; the parent's directors' conduct (and the transaction itself) will continue to be evaluated under the "entire fairness" mode of analysis," with the burden of proving "unfairness" being placed upon the plaintiff." *Id.* at 501-02; *cf.* *Cinerama, Inc. v. Technicolor, Inc.*, No. 8358, 1991 WL 111134, at *9 (Del. Ch. June 24, 1991) (Chancellor Allen recognized the conflict between the Chancery Court decisions in *TWA* and *DuPont* and noted that "[h]appily, this case does not require one to re-enter th[e] thicket" surrounding "the appropriateness of a particular form of judicial review when an allegedly independent entity has been interposed between a controlling shareholder and the effectuation of a transaction in which it is interested (i.e., committees of allegedly disinterested directors or majority of minority vote provisions)").

mote and protect the minority interests."¹⁵⁹ The court also found that the committee did not "strive to negotiate the highest or best available transaction for the shareholders," as opposed to one that simply fell "within a range of fairness."¹⁶⁰ Accordingly, the court held that the committee "did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary"¹⁶¹ and that plaintiffs had therefore raised "such substantial questions" regarding the committee's effectiveness that "no weight may be accorded to [the committee's] actions."¹⁶²

IV. CURRENT TRENDS IN BOARD COMPOSITION

As discussed above, corporate governance is a dynamic process that is constantly evolving. As courts and legislatures have recognized the benefits of having outside directors¹⁶³ serving on boards, commentators have likewise emphasized the significance that such directors play in the corporate governance structure. Indeed, the belief that outside directors play an important role in corporate governance was fostered, in part, by the publication during the late-1970s of the "white papers" by the Business Roundtable ("BRT") and the ABA. Both organizations noted "the strong tendency of U.S. business corporations to move toward a board structure based upon a majority of outside directors,"¹⁶⁴ and praised that trend. The BRT emphasized:

[i]t is our belief that in most instances — there will be exceptions based on the particular situation of an enterprise — it is desirable that the board be composed of a majority of non-management directors [T]he fact that a majority of directors have no immediate accountability for short range financial results assures greater de-

¹⁵⁹ *TWA*, No. 9844, 1988 WL 111271, at *7.

¹⁶⁰ *Id.* at *4.

¹⁶¹ *Id.* at *7.

¹⁶² *Id.* at *9.

¹⁶³ Unless otherwise noted, the term "outside director" refers to a non-employee director, and the term "inside director" refers to a director who is also a corporate officer.

¹⁶⁴ The Business Roundtable: *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 *BUS. LAW.* 2083, 2108 (1978).

tachment and a better focus on longer-range corporate interests.¹⁶⁵

Similarly, the ABA stated:

A substantial number of large, publicly held business corporations have tended increasingly in recent years to structure their boards of directors so that a majority of the board is composed of non-management directors. While it is not believed necessary that this pattern be mandated for all corporations, it is highly recommended as a means of maintaining a board and committee environment conducive to effective exercise of independent judgment.¹⁶⁶

Recent empirical data reflects that corporate America has recognized the benefits associated with having outside directors comprise a majority of corporate boards. Specifically, during the past twenty years, many corporations have nominated and elected an increasing number of non-employee directors, and many boards are now composed of a majority of outside directors. A survey of a select group of large, publicly owned corporations conducted in 1991, for example, indicated that outside directors, on average, comprised seventy-five percent of a corporation's board (each board consisting of, on average, three inside directors and nine outside directors).¹⁶⁷ In 1980, by comparison, one commentator noted:

Nearly half (48.5%) of the directors of companies with over \$150 million in assets were persons "independent" of management in a rigorous sense. These "independent" directors were not present or former officers, employees, relatives of officers, creditors, suppliers, customers, retained attorneys, investment bankers, or control stockholders of the company. In other words, the new breed of directors has no economic stake in the company, other than the relatively modest compensation associated with the directorship.¹⁶⁸

This evolution towards an outside director-dominated

¹⁶⁵ *Id.*

¹⁶⁶ ABA Comm. on Corp. Laws, *supra* note 28, at 1625 (footnote omitted).

¹⁶⁷ KORN/FERRY INT'L, BOARD OF DIRECTORS TWENTIETH ANNUAL STUDY 13 (June 1993) [hereinafter TWENTIETH ANNUAL STUDY]. See Appendix Table. One thousand companies were asked to participate in the TWENTIETH ANNUAL STUDY, and 327 responded. The companies asked to participate included the Fortune 500, the Fortune 100 major service companies, the Fortune 50 major banking institutions, 50 major insurance companies, 50 major diversified financial companies, 50 major retailers, 50 major transportation companies and 150 selected smaller companies. *Id.* at 26.

¹⁶⁸ Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 3 (1981).

board was the product of numerous factors. In addition to judicial decisions, legislative enactments and commentary, all of which emphasize the importance of outside directors, a belief by management that outside directors play an important and beneficial role in corporate governance is a significant factor that deserves emphasis. Specifically, over the last two decades, corporate managers have begun to recognize that outside directors could bring to a board several important potential advantages.

First, outside directors could utilize their experiences and perspectives to provide an extra dimension of input and, thus, assist in the corporate managers' decisionmaking process.¹⁶⁹ Indeed, many chief executive officers acknowledge that they "look to their outside directors to give them sound counsel and a broad prospective."¹⁷⁰ These directors are, in other words, "windows on the world who provide a protection against insularity and lack of vision."¹⁷¹

Second, outside directors would be well suited to serve on audit, compensation and nominating committees. Specifically, much of a board's most important management monitoring is performed by these "overview" committees. Indeed, as several commentators have noted, the effectiveness of such committees may depend on the extent to which they are composed of outside directors.¹⁷² A corporation, therefore, may benefit from having its auditing, nomination and compensation processes overseen by independent persons having no personal stake in the decisions being made.¹⁷³ Thus, by necessity, a corporate

¹⁶⁹ See KORN/FERRY INT'L, BOARD OF DIRECTORS NINETEENTH ANNUAL STUDY 17 (June 1992) (CEO's "look for people who have the experience to help set the company's direction and who possess the stature, seniority and independence to advise senior management . . .") [hereinafter NINETEENTH ANNUAL STUDY]; KORN/FERRY INT'L, BOARD OF DIRECTORS EIGHTEENTH ANNUAL STUDY 4 (June 1991) (outside directors "serve a critical function by expanding the CEO's frame of reference by bringing judgment born of extended experience . . .") [hereinafter EIGHTEENTH ANNUAL STUDY].

¹⁷⁰ Haft, *supra* note 168, at 3.

¹⁷¹ The Business Roundtable, *supra* note 164, at 2107.

¹⁷² See, e.g., ABA Comm. on Corporate Laws, *The Overview Committees of the Board of Directors*, 35 BUS. LAW. 1335, 1337 (1980); ABA Comm. on Corporate Laws, *supra* note 28, at 1625.

¹⁷³ Cf. SEC v. Falstaff Brewing Corp., 629 F.2d 62, 75 (D.C. Cir.) ("The existence of [an audit] committee implies a structured investigation and analysis of a company's fiscal welfare. Informal procedures may be adequate, but formal entities

board would need a significant number of outside directors if it was to implement such a committee structure without unduly burdening a few individuals.

Third, outside directors are relied upon to reach informed and independent decisions regarding the fairness of proposed transactions or other dealings between the corporation and affiliated persons. For example, as previously discussed, in a majority of jurisdictions, approval or ratification by disinterested directors of a transaction between the corporation and management, after full disclosure, can obviate litigation challenging the propriety of such a transaction.¹⁷⁴ Outside directors, therefore, may provide a "safe harbor" with respect to conflict-of-interest transactions.

Fourth, outside directors might be less inhibited about questioning senior management. Indeed, chief executive officers emphasize that it is beneficial to the corporation for them to have "someone they can talk with openly and candidly."¹⁷⁵ Moreover, the presence of outside directors on the board can act as a catalyst to encourage a corporation's management to formulate and present to the board informed and thorough recommendations.

Finally, the presence of prominent and disinterested persons on a corporation's board should simply enhance a corporation's image and assist in defending the board's decisions.¹⁷⁶ Outside directors, therefore, can create an overall environment conducive to effective, independent judgment.

In sum, enormous changes have occurred in the governance of public corporations during the past decade that provide internal mechanisms to resolve most intracorporate disputes—including conflict of interest transactions—without

such as committees create at least the impression of great care and precision through detailed review and oversight."), *cert. denied*, 449 U.S. 1012 (1980).

¹⁷⁴ See *supra* notes 57-59, 67-76 & 145-62 and accompanying text; see also *International Ins. Co. v. Johns*, 874 F.2d 1447, 1460-61 (11th Cir. 1989); *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987).

¹⁷⁵ EIGHTEENTH ANNUAL STUDY, *supra* note 169, at 4; *id.* ("A full 82 percent [of the 352 chief executive officers that responded to the study] stated that they like to converse with individual directors for brainstorming sessions between formal meetings."); see also NINETEENTH ANNUAL STUDY, *supra* note 169, at 5 ("CEO's look to their outside directors to give them sound counsel and a broad perspective . . .").

¹⁷⁶ See *supra* notes 57-59, 67-76 & 145-62 and accompanying text.

judicial involvement. Indeed, with the oversight provided by disinterested directors, enhanced judicial scrutiny of conflict of interest transactions (where such transactions were approved or ratified by disinterested directors) would unnecessarily increase the number of lawsuits brought against corporate fiduciaries at a time when there is general agreement that there is too much litigation in this country.¹⁷⁷

V. PROPOSED CODIFICATION OF CORPORATE LAW

In his contribution to this Symposium, Professor Seligman proposes, to some degree, federal regulation of state corporate law:

One area today where sufficient evidence has accumulated to justify possible congressional action would be the duties of loyalty and care. I would urge that this examination be limited to only the largest of the publicly traded corporations; for example, those otherwise subject to SEC jurisdiction under section 12 of the 1934 Act.

The federal fiduciary duty cause of action Congress could enact would be litigated in federal court and would expressly prohibit federal courts from deferring to special litigation committees in suits properly alleging the misconduct of *any member of the board of directors*. The federal fiduciary standard should substitute for the special litigation committee the federal courts' standards for dismissal of nonmeritorious suits. The new standard will pose some difficult drafting problems.¹⁷⁸

Professor Seligman's position ignores two facts. First, it discounts the advancements in corporate governance over the past two decades. Courts, legislatures, commentators and corporate America itself have emphasized the significance of having outside directors on a corporate board and courts and legis-

¹⁷⁷ See, e.g., John Toothman, *Greasing the Wheels for Civil-Justice Reform*, LEGAL TIMES, Jan. 18, 1993, at 43 (quoting then-President-elect Clinton for the proposition that "[t]here is too much abusive litigation in this country"); Michele Galen, *Guilty! Too Many Lawyers And Too Much Litigation: Here's A Better Way*, BUS. WK., Apr. 13, 1992, at 60 ("Every branch of government is pushing some package of legal reform. Congress is overseeing 'advisory committees' in every federal court to try to speed up cases and cut costs. Judges are overhauling the federal rules of civil procedure."); Randall Samborn, *The Battle Escalates on Reform*, NAT'L L.J., Mar. 2, 1992, at 1 ("Although pursuing similar objectives simultaneously, Congress, the courts and the Bush administration are advancing separate initiatives to reduce the cost and delay of litigation in the federal courts.")

¹⁷⁸ Seligman, *supra* note 2, at 61 (emphasis added).

latures have recognized that courts should give great deference in reviewing business decisions where the decisionmaker is not tainted by personal financial interest. Federal regulation of corporate law, as proposed by Professor Seligman, would needlessly subject to enhanced judicial scrutiny the decisions of disinterested directors (even where such directors constitute a majority of the board) whenever a corporate fiduciary is involved in "alleged misconduct."

Second, as recently demonstrated by the more-than-fourteen year odyssey travelled by the American Law Institute's ("ALI") corporate governance project,¹⁷⁹ the "difficult drafting problems" that Congress would face in attempting to codify "[t]he federal fiduciary cause of action" may be an understatement. The controversy surrounding the ALI's corporate governance project, as reflected by the numerous drafts of the project and the prolonged period of time needed for completion, demonstrates that any effort to formulate a "national" corporate law—attempting to codify the various (and differing) applications of corporate law adopted by the states—is not an easy undertaking.¹⁸⁰ Professor Seligman is inviting Congress to proceed with such an undertaking. Given the "difficult drafting problems" associated with such an endeavor and the limited need—if any—for a "federal fiduciary cause of action," this Article urges that Professor Seligman's invitation be declined.

In contrast to the position of Professor Seligman—that federal regulation of fiduciary duties is needed¹⁸¹ because state law has "increasingly erected barriers to derivative claims challenging"¹⁸² alleged misconduct by corporate fiduciaries—as demonstrated by the well-developed state law dis-

¹⁷⁹ Weil, Gotshal & Manges is counsel to The Business Roundtable's Corporate Responsibility Task Force in connection with the American Law Institute's corporate governance project.

¹⁸⁰ See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, 1992 A.L.I. (Mar. 31, 1992) (Proposed Final Draft); see also, e.g., Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443 (1993); Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992); Dooley & Veasey, *supra* note 122; Charles Hansen et al., *The Role of Disinterested Directors in "Conflict" Transactions: The ALI Corporate Governance Project and Existing Law*, 45 BUS. LAW. 2083 (1990) (each critical of various sections of the ALI corporate governance project).

¹⁸¹ See Seligman, *supra* note 2, at 62.

¹⁸² *Id.* at 60.

cussed above, the standard by which courts have reviewed claims for breach of fiduciary duties has evolved with the advancements in corporate governance. Accordingly, the creation of a "federal fiduciary duty cause of action"—as proposed by Professor Seligman (or anyone else to date)—is unnecessary offering little potential assistance with respect to modern corporate governance.

APPENDIX

PRESENT NUMBER OF BOARD MEMBERS

| Type and Size of Company | Average Number Inside Directors | Average Number Outside Directors | Average Number Directors |
|---|--|---|--------------------------------|
| Industrials | | | |
| Under \$400 million | 2 | 6 | 8 |
| \$400-599 million | 3 | 7 | 10 |
| \$600-999 million | 3 | 7 | 10 |
| \$1-2.999 billion | 2 | 8 | 10 |
| \$3-4.999 billion | 4 | 9 | 13 |
| \$5 billion & over | 3 | 10 | 13 |
| Banks and other Financial Institutions | | | |
| Insurance Companies | 2 | 11 | 13 |
| Retailers | 4 | 12 | 16 |
| Services Companies | 2 | 10 | 12 |
| Average | 2 | 9 | 11 |
| | 3 | 9 | 12 |

