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DELAWARE'S NEW SECTION 102(b)(7): BOON OR BANE FOR CORPORATE DIRECTORS?

INTRODUCTION

The obligations of a corporate director fall into two broad categories: a duty of loyalty and a duty of care.¹ A corporate director pledges allegiance to the enterprise and implicitly acknowledges that the best interests of the corporation and its shareholders must prevail over any personal interests.² This is otherwise known as a director's duty of loyalty. A corporate director also is obligated to act carefully when he monitors and directs the activities of corporate management.³ This is known as the duty of care.

The board of directors has an obligation to manage or supervise the corporation's business⁴ and is given great latitude in making decisions.⁵ Due to the business judgment rule, courts generally will not review business decisions⁶ or second guess the board's judgment.⁷ The business judgment

1. See Herzl & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986) (dividing directors' fiduciary duty into two components). See also *infra* notes 14-118 and accompanying text.

2. Subcommittee on Functions and Responsibilities of Directors, of the Committee on Corporate Laws, Section of Corporation, Banking and Business Law, American Bar Association, *Corporate Director's Guidebook*, 32 BUS. LAW. 13 (1976) [hereinafter *Guidebook I*] (setting forth basic fiduciary duties). See also Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979) (discussing fiduciary components); Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1478 (1984) (arguing for broader standards).

3. See *supra* note 2.

4. The general corporation laws provide that the business and affairs of the corporation shall be managed by or under the direction of a board of directors. See DEL. CODE ANN. tit. 8, § 141(a) (1983); REVISED MODEL BUSINESS CORP. ACT § 8.01 (1983).

5. See, e.g., *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (court upheld director's adoption of preferred share purchase rights plan as legitimate exercise of business judgment); *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (courts will not interfere with business judgment absent particularized allegations of a breach of fiduciary duty). See also Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1896-1902 (1983) (questions generally revolve around degree of discretion allowable in fulfilling corporate duties).

6. *Allaun v. Consolidated Oil Co.*, 16 Del. Ch. 318, 325, 147 A. 257, 261 (1929) (directors presumed to make business decisions correctly). The business judgment rule is a tool of judicial review, not a standard of conduct, and as such may be applied differently in varying contexts. Compare *Gimbel v. Signal Cos.*, 316 A.2d 599, 609 (Del. Ch.) (sale of assets involving minority stockholder who was granted preliminary injunction to enjoin sale of stock of wholly owned subsidiary in view of value and speed with which directors acted in approving sale), *aff'd in part*, 316 A.2d 619 (Del. 1974) with *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954

rule is a presumption that in making business decisions, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that they were acting in the best interests of the corporation.⁸ Absent proof of an abuse of discretion, the courts will respect the board's judgment.⁹

(Del. 1985) (decision by directors in response to takeover bid to affect self-tender offer for its own shares based on board's good faith; action was informed and taken with due care).

7. *Muschel v. Western Union Corp.*, 310 A.2d 904, 908 (Del. Ch. 1973) (courts will not interfere with directors' business judgments that are made "in good faith, with honest motives, and for honest ends"); *Warshaw v. Calhoun*, 43 Del. Ch. 148, 157, 221 A.2d 487, 493 (1966) (courts will not interfere with directors' business judgment in absence of bad faith or gross abuse); *Bodell v. General Gas and Elec. Corp.*, 15 Del. Ch. 420, 429, 140 A. 264, 268 (1927) (transaction will not be scrutinized as long as acts of directors were performed in good faith, in exercise of their best judgment, and for what directors believed to be advantage of corporation).

The Delaware Supreme Court formulated the principle of judicial deference by holding that a board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (courts will not substitute their own notions of what is or is not sound business judgment).

This scope of protection allows directors to make decisions that enable the board to function without concern about a serious attack upon their decisions. *See generally* Block & Miller, *The Responsibilities & Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44 (1983) (discussion of how far boards can go in deciding to fight takeovers); Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27 (1981) (boards have great discretion in decision-making); Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980) (how boards should resist hostile advances); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) (how boards can best get business judgment rule protection); Veasey, *Seeking a Safe Harbor From Judicial Scrutiny of Directors' Business Decisions—An Analysis of Framework for Litigation Strategy and Counselling Directors*, 37 BUS. LAW. 1247 (1982) (discussion of what directors must do to invoke business judgment rule).

8. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (plaintiff failed to sustain burden of showing that directors' decision was tainted); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983) ("The business judgment rule . . . is a presumption that a rational decision of an officer or director is proper unless facts exist which remove the decision from the protection of the rule."); *Bodell v. General Gas and Elec. Corp.*, 15 Del. Ch. 420, 426, 140 A. 264, 267 (1927) (decisions will not be scrutinized as long as directors acted in good faith and for advantage of corporation). *See also* *Kaplan v. Goldsamt*, 380 A.2d 556, 568 (Del. Ch. 1977) (directors' decisions made in good faith and based upon reasonable investigation and advice under circumstances); *Warshaw v. Calhoun*, 43 Del. Ch. 148, 156-57, 221 A.2d 487, 493 (1967) (directors using reasonable business judgment not subject to accounting).

The purpose of the business judgment rule is to encourage risk taking. It enables corporations to obtain competent guidance by minimizing the directors' exposure to liability and prevents courts from making decisions in areas they are ill equipped to handle. Veasey, *supra* note 7, at 1260-73 (discussion of distinction between role of courts and role of directors).

9. A plaintiff alleging that the board has breached its fiduciary duty has the burden of proof in overcoming the rule's presumption of due care and good faith. *See, e.g.*, *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980) (directors did not breach any fiduciary duties in attempting to win control of New Jersey corporation); *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980) (plaintiff charged with burden of overcoming business judgment

Thus, the business judgment rule has two major effects:¹⁰ (a) the rule prevents courts from re-examining the merits of a director's diligent and good faith

rule), *cert. denied*, 450 U.S. 999 (1981).

In recent Delaware decisions, courts have required the board, while initially bearing the burden of proof, to demonstrate a rational purpose for its decision if its actions accomplish a shift in the internal structure of the corporation whereby power is transferred from stockholders to management. See, e.g., *Norlin Corp. v. Rooney Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (management issuing new shares to ESOP which it controlled). But see *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1348 (Del. 1985) (management implementing a poison pill).

Boards have been allowed to take a wide variety of actions, however, in response to takeover threats, such as having a "white knight" seek an acquisition of the corporation. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1250 (Del. Ch. 1985) (board of target corporation had "white knight" acquire corporation in order to deter tender offer). A white knight is a favored suitor. *Mobil Corp. v. Marathon Oil Corp.*, 669 F.2d 366, 367 (6th Cir. 1981). Another action includes selling the "crown jewel." *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 291 (2d Cir. 1986) (selling SCM's food and pigment operation in lockup option was not an abuse of discretion); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986) (Revlon entered lockup to prevent takeover). A crown jewel is the most productive or profitable division of a company. Note, *Lock-up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1077 (1983). A board may also undertake acquisitions to make the target less attractive or to pose antitrust problems. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir. 1981) (Carter Hawley Hale purchase of Marshall Field prevented based upon antitrust considerations). Alternatively, the board may approve "pac-man" preemptive strikes or discriminatory self-tenders. *Unocal*, 493 A.2d at 946 (discriminatory self-tenders allowable to oppose "inadequate and coercive" tender offers). The pac-man defense is a target company's counter tender offer for the stock of the would-be acquiror, made in response to an unwanted tender offer. *Golter v. Household Int'l*, 500 A.2d 1346, 1350 n.6 (Del. 1985). Finally, the board may adopt a "poison pill." *Asarco Inc., v. Court*, 611 F. Supp. 468, 473 (D.N.J. 1985) (corporation could issue preferred stock to make takeover more difficult); *Moran*, 500 A.2d at 1348 (business judgment rule applicable to defense mechanism to ward off takeover attempt). For a definition of "poison pill," see *infra* note 173.

However, because of the inference that a director may be acting in his own interests, an enhanced duty exists that calls for judicial examination before the protection of the business judgment rule may be conferred. *Unocal*, 493 A.2d at 954. A Delaware board of directors faced with this inherent conflict must show that it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. A board can satisfy this burden by showing good faith and reasonable investigation. *Revlon*, 506 A.2d at 182 (principles of "care, loyalty and independence" must be satisfied before business judgment rule applies to actions in response to takeover threats). The approval of a majority of outside directors who have not simply deferred to management's wishes materially enhanced this proof. *Unocal*, 493 A.2d at 955.

10. The business judgment rule has been advocated in cases of "transactional justification" where an injunction is sought against board action. In this case, the focus is on the decision itself rather than the liability of the decision maker. Veasey, *New Insights Into Judicial Deference to Directors' Business Decisions: Should We Trust the Courts?*, 39 BUS. LAW. 1461, 1466-75 (1984).

The former transactional setting is sometimes said to apply to the business judgment "rule" while the latter is said to apply to the business judgment "doctrine." See Hinsey, *Business Judgment and the American Law Institute Corporate Governance Project: The Rule, the Doctrine and the Reality*, 52 GEO. WASH. L. REV. 609, 611-13 (1984) (distinguishes between business judgment rule and business judgment doctrine).

decision; and (b) the rule provides a presumption in a director's favor on the issue of due care.¹¹

In response to a perceived misapplication of the business judgment rule, the Delaware legislature recently passed a statute that limits the liability of corporate directors.¹² In order to grasp the full meaning of the new Delaware statute and its implications for Delaware corporations, this Comment will explore the duties of loyalty and care. It will then proceed to explain the new statute that the Delaware legislature enacted, *inter alia*, to exempt corporate directors from personal liability for breaches of their duty of care.¹³ Finally, this Comment will use several cases to depict how the new statute, although giving almost complete deference to the judiciary, will have little effect on directors' potential liability in many takeover situations.

I. GENERAL PRINCIPLES

A. *The Duty of Care*

The corporate director assumes the duty to act carefully when he directs and monitors the activities of management.¹⁴ The Revised Model Business Corporation Act sets forth the following legal standard:

11. The business judgment rule is flexible enough to allow for the possibility that other people may disagree with a board's decision. Indeed, a board's decision, made with the proper motivation and methodology, could be wrong and still withstand attack. *See Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (upheld directors' adoption of preferred share purchase rights plan as legitimate exercise of business judgment); *Geller v. Tabas*, 462 A.2d 1078, 1082 (Del. 1983) (decision to purchase silver futures contracts and U.S. Treasury bond futures protected against judicial scrutiny); *Huffington v. ENSTAR Corp.*, Nos. 7802, 7857, slip op. (Del. Ch. Apr. 16, 1985) (directors protected by business judgment rule concerning tender offer and sale of corporate assets agreed to be in best interests of shareholders); *Reading Co. v. Trailer Train Co.*, 483 A.2d 634 (Del. Ch. 1984) (interference with business decisions should be avoided unless either statutory or case law indicates directors have overstepped their bounds); *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (1964) (board of directors within its rights in relying upon informal personal investigations).

The view that directors should not take action on behalf of the corporation is inconsistent with the majority of jurisdictions. *See Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982). *But see American Int'l Rent-a-Car Corp. v. Cross*, No. 7583, slip op. (Del. May 9, 1984) (interference with business decisions should be avoided unless either statutory or case law indicates directors have overstepped their bounds).

12. *See infra* notes 126-32.

13. *Id.*

14. *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891) (common law legal standard binds directors to use degree of care which ordinarily prudent and diligent men would exercise under similar circumstances). *See also Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963) (expressing standard as that which "ordinarily careful and prudent men would use in like circumstances"). *But cf. Cary, Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 683-84 (1974) (discussion of Delaware's favorable tax, trust, and corporation laws); *Cary, A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974) (discussion of need for federal standards for corporation law). Professor Cary's opinion of Delaware law has been found to be extreme. *See, e.g., Arshnt, Reply To Professor Cary*, 31 BUS. LAW. 1113 (1976) (finding Cary's analysis biased and unscholarly).

A director shall discharge his duties as a director, including his duties as a member of a committee: 1) in good faith; 2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and 3) in a manner he reasonably believes to be in the best interests of the corporation.¹⁵

When inquiring into the duty of care requirement of the business judgment rule, a court examines whether or not directors have informed themselves of all material information that is reasonably available prior to making a business decision.¹⁶ The judgment of the directors must be an informed one. The court's inquiry must focus on the information and/or advice the board had available to it, and whether or not it had sufficient opportunity to acquire knowledge concerning the problem before making its decision.¹⁷ Directors have an affirmative duty to protect the financial interests of the corporation and its stockholders and must proceed with a "critical eye" in assessing information.¹⁸ Therefore, in order to secure the protection of the business judgment rule, the directors must have "brought their judgment to bear with specificity on the challenged transaction"¹⁹

In a tender offer, the directors of the target corporation must make a fully informed and reasoned response. Also, the decision to oppose the proposal must be made in good faith and must be for a rational business purpose.²⁰ If the target board did not fully consider the offer, or its consideration of the offer was merely a sham, the directors violated their fiduciary

15. REVISED MODEL BUSINESS CORP. ACT § 8.30(a) (1984). The ABA's Committee on Corporate Laws spent three years of debate on the original version of this formulation of the business judgment rule. In revising the Model Business Corporation Act, the Committee drafted no less than ten versions of the old section 35, and finally adopted it verbatim. See Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time For Reality*, 39 BUS. LAW. 1477, 1478 (1984). It should be noted, however, that in its comment to the REVISED MODEL BUSINESS CORP. ACT, the ABA's Committee on Corporate Laws stated that "[S]ection 8.30 does not try to codify the business judgment rule or to delineate the differences . . . between that rule and the standards of director conduct set forth in this section." REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984) (Committee Comment).

16. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (invocation of business judgment rule protection requires standard of care that is less exacting than simple negligence).

17. *Kaplan v. Goldsamt*, 380 A.2d 556, 568 (Del. Ch. 1977) (price paid to former director for stock and noncompetition agreement determined in good faith); *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971) (exchange of stock to obtain interest in other corporations accomplished as result of "independent business judgment").

18. *Smith v. Van Gorkom*, 488 A.2d 858, 890 (Del. 1985).

19. *Id.* See also *Weinberger v. United Fin. Corp.*, 405 A.2d 134, 137 (Del. Ch. 1979) (proposed merger could not be said to be grossly unfair or constitute fraudulent act on part of board); *Gimbel v. Signal Cos.*, 316 A.2d 599, 609 (Del. Ch. 1974) (shareholder injunction granted based on conflicting evidence as to value of sale of stock in wholly owned subsidiary and in view of speed with which board approved sale); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (directors also involved as directors of other corporations with whom corporation dealt); *Lutz v. Boas*, 39 Del. Ch. 585, 608, 171 A.2d 381, 396 (1961) (nonaffiliated directors of investment company have same responsibility as ordinary directors of Delaware corporation).

20. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986).

duty.²¹ However, to show that the board's actions were outside the scope of the business judgment rule, the plaintiff must prove that the board acted without sufficient information and that it had approved an "unintelligent and unadvised decision."²²

To determine whether or not a board of director's decision was sufficiently informed, courts utilize a gross negligence standard.²³ Directors are not expected to know all the intricacies of defensive tactics and they need not read in total every contract or legal document that they approve.²⁴ Directors generally can demonstrate compliance with the duty of care if they: (a) prove that they were supplied, in advance of a board meeting, with the documentation of proposed or alternative courses of action, and (b) then show that they conducted extensive discussions with their legal and financial advisors in order to receive a full evaluation of the proposal's strengths and weaknesses.²⁵

Frequently, however, the target board must respond quickly and may have only a short time to evaluate the proposed offer and its possible alternatives.²⁶ If the board has a pre-planned defense, the board could be attacked for its failure to fully consider the offer.²⁷ This timing problem is unique because not only does the marketplace pressure the board into making a decision, but the Securities and Exchange Commission also exerts pressure through its disclosure requirements.²⁸ These rules require a target company to announce its position, with respect to a tender offer, within ten business days of the date the offer is first published.²⁹ The target board must issue a

21. *Smith v. Van Gorkom*, 488 A.2d at 882. See also *Royal Indus., Inc. v. Monogram Indus., Inc.*, Fed. Sec. L. Rep. (CCH) § 95,863 (D. Cal. Nov. 1976) (directors never fully considered offer).

22. *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 615 (Del. Ch.) (quoting *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 330, 167 A. 831, 833 (1933)), *aff'd per curiam*, 316 A.2d 619 (Del. 1974). Many courts, however, presumably would disregard the inference to the "unintelligent" decision mentioned in *Gimbel* above. The Second Circuit has stated:

Directors are not specialists, like lawyers or doctors. They must have good sense, and perhaps they must have acquaintance with affairs; but they need not—indeed, perhaps they should not—have any technical talent. They are the general advisors of the business, and if they faithfully give such ability as they have to their charge, it would be harmful to hold them liable.

Barnes v. Andrews, 298 F. 614, 618 (2d Cir. 1924).

23. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Smith v. Van Gorkom*, 488 A.2d at 873.

24. *Smith v. Van Gorkam*, 488 A.2d 858 (Del. 1985).

25. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985).

26. *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (1962) (board given forty-eight hours to make decision).

27. The *Moran* court failed to fully consider this possibility when it approved the Household board's adoption of a poison pill defense that was set in place before any attack was mounted against the corporation. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

28. See Securities and Exchange Act of 1934, 17 C.F.R. § 240.14e-2 (1981). 15 U.S.C. §§ 78(m)-(n) (1982). This statute is better known as the Williams Act.

29. See *supra* note 28.

disclosure statement that recommends acceptance or rejection, or explicitly states that it has no opinion or remains neutral with respect to the offer.³⁰ This statement also must set forth the board's reasoning.³¹

Delaware courts have interpreted the Delaware Corporation Code as providing full protection to directors who rely in good faith on a corporate officer's reports and informal personal investigations.³² However, such reports must relate directly to the subject matter upon which the board is called to act. Corporate officers, meanwhile, must provide all relevant information to the board in order for the directors to rely on management's reports.³³ The circumstances may be such that the board must make a reasonable inquiry into any reports submitted to the board.³⁴ For example, the report might indicate that the company is a likely takeover target.

Delaware law does not require directors to obtain investment bankers' evaluations or fairness opinions.³⁵ By relying on investment bankers, accountants, and outside counsel, however, directors may better demonstrate that their decision to resist a hostile takeover was made in good faith. But reliance upon expert advice may not be used as a sham to cover a board's otherwise improper action.³⁶

Although courts and legislatures have expressed differing standards of care that directors must use, most variations still rely upon what the ordinarily prudent person under similar circumstances would do.³⁷ However, few authors agree on the level of care required by such standards. The two tests

30. 17 C.F.R. § 240.14e-2 (1981). *See also* A & K R.R. Materials v. Green Bay & Western R.R., 437 F. Supp. 636, 644 (E.D. Wis. 1977) (management must be careful to disclose all possible conflicts of interest in connection with tender offer).

31. *See supra* note 30.

32. Section 141(e) of the Delaware General Corporation Law states:

[A] member of the board of directors of any corporation organized under this chapter . . . shall, in the performance of his duties, be fully protected in relying in good faith upon the books of account or reports made to the corporation by any of its officers, or by an independent certified public accountant . . . or in relying in good faith upon other records of the corporation.

DEL. CODE ANN. tit. 8, § 141(e) (1983).

33. *Id.*

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

35. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 950-52 (Del. 1985) (management fully briefed board before vote). *But see Smith v. Van Gorkom*, 488 A.2d at 862-70 (CEO and CFO withheld valuation from board).

36. *See generally Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980) (board asked investment banker to prepare pro forma balance sheets of consolidated companies, sent questions to target through investment banker, and adjourned for one week to "reflect on the information"); *Smith v. Van Gorkom*, 488 A.2d at 872-73 (discounting reports submitted to board by in-house experts); *Joseph v. Shell Oil Co.*, 482 A.2d 335, 342 (Del. Ch. 1984) (failure to disclose with "complete candor" circumstances surrounding preparation of investment banker's fairness opinions led to injunction against tender offeror standing on both sides of transaction since it owed duty to target's minority shareholders).

37. *See supra* note 15.

most often used are the ordinary care test,³⁸ that uses ordinary negligence to determine liability, and the gross negligence test.³⁹

In *Aronson v. Lewis*,⁴⁰ the Delaware Supreme Court held that the business judgment rule protects directors if they have informed themselves of all material information reasonably available to them prior to making a business decision.⁴¹ The board then can act with the requisite care to discharge its duties.⁴² The court concluded that "under the business judgment rule director liability is predicated upon concepts of gross negligence."⁴³

One year later, in *Smith v. Van Gorkom*,⁴⁴ the Delaware Supreme Court found Trans Union's board of directors grossly negligent after it had evaluated a merger proposal and recommended the merger for shareholder approval.⁴⁵ Faced with a very short deadline within which to respond to a tender offer, the board met hastily and took action in a two hour meeting. The court found this action, taken without advance notice, adequate consideration, support staff, valuation information, or understanding of the merger agreement, to be a breach of the directors' duty of care.⁴⁶ The court accordingly denied the protection of the business judgment rule and held the directors personally liable for damages that resulted from their actions.⁴⁷

The *Van Gorkom* decision has sparked intensive controversy and criticism in the corporate boardroom because many decisions regarding tender offers apparently are made in the same manner as the Trans Union board's

38. *Francis v. United Jersey Bank*, 87 N.J. 15, 34, 432 A.2d 814, 823 (1981) (New Jersey law uses ordinary negligence); *Hunt v. Aufderheide*, 330 Pa. 362, 366, 199 A. 345, 347 (1938) (directors must use reasonable and ordinary care, skill, and diligence).

39. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (directors' liability predicated upon concepts of gross negligence); *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 381 F. Supp 1003, 1013 (D.D.C. 1974) (trustee's breach of fiduciary duty to supervise management of hospital's investments). See generally *Arsht & Hinsey, Codified Standard—Same Harbor but Charted Channel: A Response*, 35 BUS. LAW. 947 (1980) (adoption of section 35 of Model Business Corporation Act would give certainty to level of conduct required of director); *Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1101 (1968) (trend in affording directors protection against liability should be curtailed); *Veasey, supra* note 10, at 1470 (analysis of Delaware standard of care when gross negligence standard used); *Veasey & Manning, Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1980) (different formulations of applicable standards of care may not necessarily render different results); *Veasey & Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483 (1985) (discussion of desirability of codifying business judgment rule).

40. 473 A.2d 805 (Del. 1984).

41. *Aronson v. Lewis*, 473 A.2d at 812.

42. *Id.*

43. *Id.*

44. 488 A.2d 858 (Del. 1985).

45. *Id.* at 881.

46. *Id.* at 875.

47. *Id.* at 893.

decision.⁴⁸ In *Van Gorkom*, the Delaware Supreme Court applied the concept of gross negligence in a very fact-specific situation. While both the *Van Gorkom* and the *Aronson* decisions are based on the court's deference to the business judgment of directors and the protection from liability that flows therefrom,⁴⁹ the courts will require a board to investigate thoroughly and carefully when making a decision.⁵⁰ If a board uses the services of an outside expert to make its decision and shows its due diligence, *Van Gorkom* illustrates that an expert's report must appear credible on its face. The board may not blindly and uncritically accept the report.⁵¹

Less than four months after *Van Gorkom*, the Delaware Supreme Court retreated from its hard line stance in *Unocal Corp. v. Mesa Petroleum Co.*⁵² The court held that the business judgment rule protected Unocal's self-tender offer for its own stock which arbitrarily excluded Mesa's holdings of Unocal.⁵³ *Unocal*, unlike *Van Gorkom*, involved the business judgment rule in both a defensive situation and in a claim that asserted the board's lack of due care in taking hasty, significant, and costly action to thwart a tender offer. In *Unocal*, T. Boone Pickens, Mesa's chairman, initiated a tender offer for Unocal's stock.⁵⁴ When the Unocal board of directors made its own counter offer for all Unocal stock, except those shares that Pickens's group held, Mesa sued, claiming that Unocal's offer was both unfair and overly expensive.⁵⁵ The court stated that the Unocal board's actions were "reasonably related to the threat posed."⁵⁶

Presently in Delaware, the duty of care requires a director to exercise the judgment of the ordinarily prudent person. In a takeover situation, a director must carefully evaluate all possible alternatives to invoke the protection of the business judgment rule.⁵⁷ In most instances, his decision need not be intelligent, but must be informed.⁵⁸ Above all, a director must act in good

48. See Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 Bus. Law. 1437 (1985). Cf. Veasey & Seitz, *supra* note 39, at 1499 (indicating that the *Trans Union* decision has been criticized).

49. Smith v. Van Gorkom, 488 A.2d at 890; Aronson v. Lewis, 473 A.2d at 815.

50. Smith v. Van Gorkom, 488 A.2d at 890.

51. *Id.* at 883 n.25.

52. 493 A.2d 946 (Del. 1985).

53. *Id.* at 952.

54. Pickens offered \$54 per share for 37% of Unocal's stock. The remaining 63% of the shareholders were to get subordinated debt. This was held to be coercive because it would force shareholders into stampeding to get the cash so as not to be caught "holding the bag" with debt. *Unocal*, 493 A.2d at 949-52.

55. *Id.* at 953-54.

56. *Id.* at 955. *But cf.* EAC Indus. v. Frantz Mfg. Co., 501 A.2d 401 (Del. 1985) where the court condemned the board's hastily called meeting amidst the aura of inevitability that surrounded the transaction. The court distinguished this case from *Unocal* and held that the business judgment rule will not protect a board where stockholder control has shifted and a lame-duck board attempts a hasty defensive measure. *Id.* at 408.

57. See *supra* notes 4-11 and accompanying text.

58. See *supra* note 9 and accompanying text.

faith and with a reasonable basis for believing that the action authorized is legitimately in the best interests of the corporation and its shareholders.⁵⁹

B. *The Duty of Loyalty*

In addition to his duty of care, a director owes a duty of loyalty to the corporation.⁶⁰ The basis for this duty is the director's responsibility to the corporate shareholders. Most shareholders of large, publicly traded corporations are virtually powerless to influence control over the corporation. Shareholders entrust the directors to oversee the management so as to protect their investment.⁶¹ Directors, therefore, are charged with the duty of loyalty to the corporation.⁶²

The duty of loyalty mandates that the director refrain from self-dealing.⁶³ In most instances, courts will strike down a board's approval of transactions intended to enhance the personal financial gain of the directors who participated in the decision.⁶⁴ When a director votes on such a transaction where personal gain is involved, he becomes an "interested director."⁶⁵ At common

59. See generally *Corporate Director's Guidebook: Comments Submitted by the American Society of Corporate Secretaries*, 33 BUS. LAW. 321 (1978) [hereinafter *Guidebook II*] (discussion of corporate directors' standards of conduct).

60. See generally ABA Corporate Laws Committee, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1599 (1978) [hereinafter *Guidebook III*] (discussing basic fiduciary duties); Goldstein, *Revision of the Model Business Corporations Act*, 63 TEX. L. REV. 1471 (1985) (addresses applicability of 1984 amendments to Model Business Corporation Act provisions on "corporate governance"); Ruder, *Duty of Loyalty—A Law Professor's Status Report*, 40 BUS. LAW. 1383 (1983) (discussion of fiduciary principles as basis for duty of loyalty obligation).

61. See Ruder, *Protections for Corporate Shareholders: Are Major Revisions Needed?*, 37 U. MIAMI L. REV. 243 (1983) (review of current state and federal laws and regulations including description of various proposals for changes of such laws).

62. Statements on fiduciary duty by Judge Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928) are frequently quoted:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.

Id. at 464, 164 N.E. at 546. Cf. *Electronic Dev. Co. v. Robson*, 148 Neb. 526, 540, 28 N.W.2d 130, 139 (1927) ("[The] property of the corporation constitutes a trust fund in the hands of its officers and directors, and a transaction between them whereby the corporation's property is diverted from the corporation to their own use and benefit will not be upheld.').

63. See generally *Guidebook I*, *supra* note 2, at 14 (director must present opportunity to corporation first).

64. See *Id.* at 13.

65. *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984) (instituting a "demand futility test" to determine whether directors are disinterested and independent); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("[D]irectors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit . . ."); *Kaplan v. Goldsamt*, 380 A.2d 556 (Del. Ch.

law, interested director transactions were voidable regardless of the fairness to the corporation or the approval of disinterested directors.⁶⁶ By 1960, transactions were not voidable if they were fair to the corporation and if a majority of disinterested directors approved the transaction.⁶⁷

Many states have since codified a director's duty by adopting "safe harbor" statutes. In the majority of states, the safe harbor statute will validate a transaction where a conflict exists if: (1) either informed directors or a majority of stockholders approve the decision; or (2) the decision is shown to be fair on its face.⁶⁸ The rationale behind such legislation is that when a board is fully informed and still votes to authorize the transaction, such a business decision is outside the court's realm.⁶⁹ Similarly, disinterested, fully informed shareholder approval "sanitizes" an interested director's transaction.⁷⁰

Delaware has adopted such a safe harbor statute.⁷¹ The business judgment rule is invoked if the fully informed, disinterested directors or a majority of

1977) (plaintiff failed to establish that management abused discretion in purchase of former director's stock and noncompetition agreement); *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964) (directors not bound by statements in minutes that stock option plan was motivating reason for authorization of purchase of company's shares).

66. Such transactions were voidable at the suit of a shareholder or the corporation. See *Wardell v. Union Pac. R.R.*, 103 U.S. 651 (1880); *Memphis & C. R. Co. v. Wood*, 88 Ala. 630, 7 So. 108 (1889); *Davis v. Mallory-Wheeler Co.*, 61 Conn. 131, 23 A. 708 (1891); *European & North Am. Ry. v. Poor*, 59 Me. 277 (1871); *Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co.*, 16 Md. 456 (1860); *Pearson v. Concord R.R.*, 62 N.H. 537 (1883). See also *Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 Bus. LAW. 35, 36 (1966) (transactions voidable irrespective of fairness).

67. See *Marsh, supra* note 66, at 43 (by 1960, general rule was that no transaction was automatically voidable at suit of shareholder); *Ruder, Duty of Loyalty-A Law Professor's Status Report*, 40 Bus. LAW. 1383, 1388 (1983) (contract voidable at insistence of corporation or its shareholders if majority of board is interested, irrespective of question of fairness).

68. According to the American Law Institute *Principles of Corporate Governance: Analysis and Recommendations*, § 508 (Tent. Draft No. 3, 1984), thirty-eight states have adopted safe harbor statutes. Thirty-five of these states preclude attack on a transaction when disinterested directors or shareholders approve it following disclosure. Twenty-two statutes only require disclosure of the director's interest in the transaction. Sixteen states explicitly require disclosure of both the conflict of interest and the material facts concerning the transaction.

69. *Id.*

70. *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 178-79, 91 A.2d 57, 58 (when shareholders ratified directors' approval of stock option plans, objecting shareholder had burden to prove lack of sound business judgment), *rev'd and remanded*, 33 Del. 283, 92 A.2d 594 (1952) (in action to cancel option agreement, court required proof that value of options was disproportionate as consideration with respect to services rendered).

71. The statute provides as follows:

- (a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the

shareholders ratify the action. The statute does not mandate judicial inquiry.⁷² The court's only inquiry is whether or not the consideration paid in the transaction was so inadequate that a reasonable person would conclude that the transaction was a gift or a waste of corporate assets.⁷³

Questions regarding the duty of loyalty may arise in various other contexts, but can be categorized in four general areas: fairness, conflict of interest, corporate opportunity, and confidentiality.⁷⁴ In order to focus upon the procedural considerations that often determine these issues, one must decide: (a) if adequate disclosure was made to the decision makers; (b) if the transaction with the alleged conflict of interest received independent scrutiny; (c) if the burden of proving a breach of the duty of loyalty was met; and (d) if the transaction was fair.⁷⁵ The four general areas that comprise the duty of loyalty will be discussed in detail below.

1. Fairness

A corporate director always must be aware of his obligation of fairness. If a transaction involves the corporation and an interested director, creating a possible conflict of interest, the transaction must receive the entire board's primary attention.⁷⁶ The usual standard is whether or not the proposed transaction, involving an interested director, is as favorable to the corporation as one from an outside source.⁷⁷ If the transaction might adversely affect minority shareholders, all directors must be concerned with their

contract or transaction, or solely because his or their votes are counted for such purpose, if:

- (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
- (2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by a vote of the shareholders; or
- (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

DEL. CODE ANN. tit. 8, § 144(a) (1974). Cf. REVISED MODEL BUSINESS CORP. ACT § 8.31 (1984) (articulating directors' conflict of interest transactions).

72. DEL. CODE ANN. tit. 8, § 144(a) (1974).

73. See *Pogostin v. Rice*, 480 A.2d 619, 625-26 (Del. 1984) (excessive payments to directors and officers from compensation plan tied to stock's market price).

74. See ABA Corp. Laws Committee, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591 (1978).

75. Ruder, *supra* note 67, at 1387.

76. *Fleigler v. Lawrence*, 361 A.2d 218 (Del. 1976) (president misappropriated stock options for himself). See also Marsh, *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 39-43 (1966) (approval of disinterested directors required).

77. *Guidebook I*, *supra* note 2, at 13.

obligations, especially if the transaction pits a dominant or controlling shareholder against the minority holders.⁷⁸

In *Weinberger v. UOP, Inc.*,⁷⁹ the Delaware Supreme Court required "entire" fairness in interested director transactions. Entire fairness requires a showing of both fair dealing and fair price.⁸⁰ Fair dealing centers on the timing of the transaction: how it is initiated, structured, negotiated, disclosed, and the manner in which the directors and shareholders approve the transaction.⁸¹ Fair price embraces both economic and financial considerations.⁸² The *Weinberger* court noted that the test for fairness is not split between fair dealing and fair price.⁸³ All aspects of the issue are examined as a whole.⁸⁴ Whether or not management adequately discloses information to disinterested directors is an issue in the analysis of fair dealing.⁸⁵ Nevertheless, if the price is fair, inadequate disclosure may not necessarily establish an independent basis for invalidating an interested transaction.⁸⁶ As long as the entire transaction is fair within the meaning of *Weinberger*, the transaction will be upheld.⁸⁷

78. For cases that go into depth on the obligations of majority shareholders to minority shareholders, see *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956) and *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947).

79. 457 A.2d 701 (1983). See also *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599-600 (Del. Ch. 1986) ("When the test of the intrinsic fairness of a self-interested transaction is employed, the ultimate question is whether the terms of the transaction itself are entirely or intrinsically fair.").

80. 457 A.2d at 711.

81. *Id.*

82. *Id.* See also Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms Under Delaware Law*, 2 DEL. J. CORP. L. 44, 46-47 (1977) (analysis of financial and economic aspects of fairness doctrine); Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674, 676 (1979) (discussion of Intrinsic Fairness Doctrine). But see DEL. CODE ANN. tit. 8, § 262(h) (1974) (providing appraisal remedy for shareholders dissatisfied with payment to be received in cash-out merger). The *Weinberger* court indicated that this appraisal remedy may be inadequate where there has been fraud, misrepresentation, self-dealing, gross overreaching, or a waste of corporate assets. 457 A.2d at 714. For more opinions construing the *Weinberger* appraisal remedy, see *Joseph v. Shell Oil Co.*, 482 A.2d 335 (Del. Ch. 1984); *Rabkin v. Philip A. Hunt Chem. Corp.*, 480 A.2d 655, 660 (Del. Ch. 1984), *rev'd on other grounds*, 498 A.2d 1099 (Del. 1985); *Wilen v. Pollution Control Indus.*, No. 7524, slip op. (Del. Ch. Oct. 15, 1984).

83. *Weinberger v. UOP, Inc.*, 457 A.2d at 711.

84. *Id.*

85. *Id.*

86. *Id.*

87. Post-*Weinberger* decisions underscoring the procedural problems include: *Rabkin v. Philip A. Hunt Chem. Corp.*, 480 A.2d 655 (Del. Ch. 1984) (absence of shareholder allegations of nondisclosure or misrepresentation prevented recovery for damages due to breach of fiduciary duty), *rev'd on other grounds*, 498 A.2d 1099 (Del. 1985); *Wilen v. Pollution Control Indus.*, No. 7524, slip op. (Del. Ch. Oct. 15, 1984) (the "[A]bsence of arm's length negotiations, standing alone, does not state a legally cognizable claim."); *Lewis & Marewich v. Chanan Indus.*, No. 7738, slip op. (Del. Ch. Sept. 20, 1984) (nondisclosure of certain appraisals of assets and tax loss carryforwards in tender offer and merger proposal not considered material);

The Delaware safe harbor statute⁸⁸ then provides that a transaction with an interested director is not void solely due to a conflict of interest, provided that: (a) full disclosure of all facts relating to the transaction has been made; and (b) a majority of disinterested directors or shareholders approve the transaction in good faith.⁸⁹ Otherwise, the transaction will be valid only if it can be shown to be fair to the corporation.⁹⁰ The burden of proof in this situation will be on the directors.⁹¹ In *Fliegler v. Lawrence*,⁹² for example, the Delaware Supreme Court determined that because the defendants were involved on both sides of the transaction, the burden was on them to demonstrate its intrinsic fairness.⁹³

2. Conflicts of interest

Closely related to the concept of fairness is the duty to refrain from self-dealing.⁹⁴ When a corporate director has a material interest in a proposed transaction, the director must disclose the extent and nature of such interest to the other directors before the board of directors takes action.⁹⁵ The interested director should then abstain from voting on the particular transaction and all related transactions. The interested director also must be aware of voting and quorum requirements. In Delaware, the interested director's

Weinberger & Star v. Meenan Oil Co., Nos. 7291, 7310, slip op. (Del. Ch. Sept. 10, 1984) (no finding of material nondisclosures led to dismissal of complaint for breach of fiduciary duty). *But cf.* *Joseph v. Shell Oil Co.*, 482 A.2d 335 (Del. Ch. 1984) (minority met the burden of showing reasonable probability that majority had not offered fair price). *See also* Berger & Allingham, *A New Light in Cash-Out Mergers: Weinberger Eclipses Singer*, 39 BUS. LAW. 1 (1983) (comparison of *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977) and *Weinberger*); Henzel & Colling, *Squeeze Out Mergers in Delaware—The Delaware Supreme Court Decision in Weinberger v. UOP, Inc.*, 7 CORP. L. REV. 195 (1984) (general discussion of *Weinberger*).

88. DEL. CODE ANN. tit. 8, § 144 (1953).

89. *Id.*

90. The principle Delaware case, deciding the circumstances under which the fairness test is applicable, is *Puma v. Marriott*, 282 A.2d 693 (Del. Ch. 1971). In *Puma*, the disinterested directors persuaded the court not only of their independence, but also of their care in negotiating fair terms. The court ultimately held that the business judgment rule applied and that it would not make its own determination of fairness. *Id.* at 695.

91. *See* DEL. CODE ANN. tit. 8, § 144(a) (1953).

92. 361 A.2d 218 (Del. 1976).

93. *Id.* at 222. In *Fliegler*, approximately one-third of the disinterested shareholders voted. *Id.* In *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), the court held that where a parent controls a subsidiary and also controls a transaction between itself and the subsidiary, the burden of proof may shift to the parent to defend the transaction, and a standard of "intrinsic fairness" may be applied. *Id.* at 720. *See also* Ruder, *supra* note 67, at 1389-90 (taking strict view of conflict of interest cases). *But see* *Gottlieb v. Hayden Chem. Corp.*, 33 Del. Ch. 177, 178-79, 91 A.2d 57, 58 (1952) (where directors vote to give themselves stock options subject to shareholders' ratification, burden of proof shifts to objector), *rev'd and remanded*, 33 Del. Ch. 283, 92 A.2d 594 (1953).

94. *See Guidebook I, supra* note 2, at 13.

95. *See supra* notes 60-62 and accompanying text.

attendance will count in determining quorum, while his vote of consent will not.⁹⁶

Delaware court decisions suggest that material circumstances and information that indicate a possible conflict of interest on the part of one or more directors may have to be disclosed.⁹⁷ A prudent board should make disclosures if conflicts exist.⁹⁸ The disclosure parameters, therefore, are defined more efficiently by what need not be disclosed.

Generally, no duty exists to clutter a document with insignificant information provided that, viewed in its entirety, it gives directors all relevant material necessary to decide how to vote on an issue.⁹⁹ Corporate officials are not required to admit alleged wrongdoing¹⁰⁰ or mismanagement, to speculate on improper motives,¹⁰¹ or to draw inferences from facts.¹⁰² The rationale is that the board would otherwise be required to admit possible wrongdoing before the document is admitted in a court of law.¹⁰³ Facts need not be disclosed that are known or reasonably available to the shareholders.¹⁰⁴ Opinions, conclusions, speculation, or legal theories do not have to be disclosed.¹⁰⁵ Management also has no obligation to give shareholders legal or investment advice, such as who may legally challenge a merger or the

96. DEL. CODE ANN. tit. 8, § 141(b) (1953).

97. *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858, 876-78 (Del. 1985) (proxy statement defective in failing to disclose fact that member of management prepared preliminary valuation report to justify price offered in leveraged buy-out proposal). *See also* Weinberger v. United Fin. Corp. of Cal., 405 A.2d 134, 136 (Del. Ch. 1982) (proxy statement allegedly failed to disclose that two directors of company would continue to be employed after solicited merger).

98. *Cf.* Weingaden v. Meenan Oil Co., No. 7397, slip op. (Del. Ch. 1985) (need not disclose tax advantages accruing to two directors through merger because not material).

99. Bershad v. Curtiss-Wright Corp., No. 31295, slip op. (Del. Dec. 30, 1987) (no duty to disclose general merger discussions or casual inquiries). *See also* TSC Indus. v. Northway, Inc., 426 U.S. 438 (1976) (document must contain all facts that reasonable shareholder might consider important); Field v. Allyn, 457 A.2d 1089, 1100 (Del. Ch.) (reasonable shareholder could understand since outline of acquisition was disclosed), *aff'd*, 467 A.2d 1274 (Del. 1983); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977) (directors must disclose only germane facts to shareholders).

100. A & K R.R. Materials v. Green Bay & W. R.R., 437 F. Supp. 636, 644 (E.D. Wis. 1977) (if any statements are made, they must not be materially misleading).

101. Schreiber v. Pennzoil Co., 419 A.2d 952, 961 (Del. Ch. 1980) (plaintiff must prove improper motives).

102. *Cf.* Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947) (majority stockholder is fiduciary and has burden of showing good faith and inherent fairness of proposed transaction).

103. Seibert v. Harper & Row Pub., No. 6639, slip op. (Del. Ch. Dec. 5, 1984) (proxy statement not defective in failing to disclose that termination of retirement plan allegedly would serve no proper purpose and would impair corporation's ability to attract management). *See also* Weinberger v. United Fin. Corp. of Cal., 405 A.2d 134, 136-37 (Del. Ch. 1982) (board not required to admit alleged failure to consider merger proposal prior to acceptance). *But see* Smith v. Van Gorkom, 488 A.2d 858, 891 (Del. 1985) (board should have admitted that no valuation of company was made).

104. Seibert v. Harper & Row Pub., No. 6639, slip op. (Del. Ch. Dec. 5, 1984) (need not disclose fact that investment banker considered value of control premium in giving opinion of fairness of price).

105. Edelman v. Phillips Petroleum Co., Nos. 7899, 7972, slip op. (Del. Ch. June 3, 1986)

nature of an expert's opinion on the fair value of its stock,¹⁰⁶ nor does management have a duty to disclose alternatives to the merger proposal.¹⁰⁷ Finally, the board is not obligated to disclose any other parties' inquiries into the purchase of the corporation.¹⁰⁸ Thus, the duty of loyalty requires an examination of disinterestedness and the quality and quantity of disclosure. Exactly when a fairness showing is required will depend upon the facts and circumstances surrounding each case.

3. *Corporate opportunity*

A well-recognized common law principle holds that one entrusted with the management of a corporation, such as an officer or director, occupies a fiduciary relationship to the corporation and may not exploit his position by appropriating to himself a business opportunity that properly belongs to the corporation.¹⁰⁹ If personal gain usurps such a business opportunity, the opportunities and property acquired by the fiduciary are subject to a constructive trust for the benefit of the corporation.¹¹⁰ This principle, known as the doctrine of corporate opportunity, derives from agency theory whereby the agent owes the duties of good faith and loyalty to the principal.¹¹¹

The initial inquiry is to determine whether or not the opportunity was one that belonged to the corporation. Courts have struggled with different tests to resolve this question.¹¹² Delaware courts have indicated that an opportunity

(need not disclose plaintiff's opinion on illegality of proposed recapitalization plan); *Siebert*, No. 6639, slip op. (Del. Ch. Dec. 5, 1984) (need not disclose shareholder's opposition to repossession proposal).

106. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (directors must disclose to stockholders all information that reasonable stockholder would consider important in deciding whether to sell stock). See also *Fisher v. United Technologies Corp.*, No. 5847, slip op. (Del. Ch. May 12, 1981) (proxy statements are not intended to provide legal advice to stockholders wishing to oppose a transaction), reprinted in 6 DEL. J. CORP. L. at 384.

107. See *supra* note 106.

108. *Bershad v. Curtiss-Wright Corp.*, No. 5830, slip op. (Del. Ch. Feb. 1, 1984).

109. *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939) (entrepreneur misappropriated Pepsi-Cola formula). See also *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928) (Judge Cardozo applied the corporate opportunity doctrine in partnership setting).

110. See, e.g., *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (1939) (discussing corporate loyalties). See generally *Brudney & Clark, A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981) (criticizing vague standards applied in corporate opportunity context).

111. See *supra* note 60.

112. *Miller v. Miller*, 301 Minn. 207, 222-23, 222 N.W.2d 71, 79-80 (1974). The court stated:

We have searched the case law and commentary in vain for an all-inclusive or 'critical' test or standard by which a wrongful appropriation can be determined and are persuaded that the doctrine is not capable of precise definition. Rather, it appears that courts have opened or closed the business opportunity door to corporate managers upon the facts and circumstances of each case and by application of one or more of three variant but often overlapping tests or standards: (1) The 'interest or expectancy' test, which precludes acquisition by corporate officers of the property of a business opportunity in which the corporation has a 'beachhead' in the sense

belongs to a corporation if it falls either directly within the corporation's line of business or at least in an area where the corporation has a general interest.¹¹³ Generally, when an outsider presents a business opportunity to a corporate officer that the corporation is financially able to undertake, and that falls in the line of the corporation's business and is of practical advantage to it, or is an opportunity in which the corporation has an actual or expectant interest, the officer is prohibited from taking the opportunity for himself.¹¹⁴

The types of activities included in the corporation's line of business also must be examined. These are activities that the corporation has the ability and experience to pursue and that are consistent with its reasonable needs and aspirations for expansion.¹¹⁵ If the opportunity is closely tied to the corporation's business, a director who takes such opportunity for himself may find himself liable for his actions.¹¹⁶

4. Confidentiality

The director should deal in confidence with all matters involving his corporation until general public disclosure is made.¹¹⁷ The confidentiality of

of a legal or equitable interest or expectancy growing out of a preexisting right or relationship; (2) the 'line of business' test, which characterizes an opportunity as corporate whenever a managing officer becomes involved in an activity intimately or closely associated with the existing or prospective activities of the corporation; and (3) the 'fairness' test, which determines the existence of a corporate opportunity by applying ethical standards of what is fair and equitable under the circumstances.

Id.

113. *Equity Corp. v. Milton*, 43 Del. Ch. 160, 165, 221 A.2d 494, 497 (1966). In *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 963 (Del. 1980), the court examined the corporation's financial ability to take advantage of the opportunity, whether or not it was within the corporation's line of business, and whether or not the corporation had an interest in the opportunity.

114. *Equity Corp. v. Milton*, 43 Del. Ch. at 164, 221 A.2d at 497 (citing *Guth v. Loft, Inc.*, 23 Del. Ch. 225, 269, 5 A.2d 503, 509-10 (1939)). See also *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976) (defendant directors have burden of showing intrinsic fairness of the transaction); *Kaplan v. Fenton*, 278 A.2d 834, 836 (Del. 1971) (directors not liable for failing to offer opportunity to corporation, since corporation turned down identical offer one month before); *Schreiber v. Bryan*, 396 A.2d 512, 517 (Del. Ch. 1978) (plaintiff stockholders have no standing to complain if defendants' transaction was fully disclosed to all shareholders); *Johnston v. Greene*, 35 Del. Ch. 479, 489, 121 A.2d 919, 925 (1956) (director of corporation has burden of showing transaction is fair); *Klinicki v. Lundgren*, 298 Or. 662, 683-84, 695 P.2d 906, 915 (1985) (corporate officer, acting for new corporation, misappropriated opportunity and could not contend that original corporation did not have financial ability to pursue opportunity). *But see Burg v. Horn*, 380 F.2d 897, 900 (2d Cir. 1967) (because plaintiff knew that defendant directors owned similar corporations when plaintiff asked them to be on his board, defendants did not have to bring opportunities to plaintiff's corporation first); *Solimine v. Hollander*, 128 N.J. Eq. 228, 252, 16 A.2d 203, 214-15 (1940) (corporation has no expectant interest in opportunity if it comes to director in individual capacity).

115. *Guth v. Loft, Inc.*, 23 Del. Ch. at 279, 5 A.2d at 514.

116. *Id.* at 280, 5 A.2d at 514.

117. *Guidebook III*, *supra* note 60, at 1600.

all current corporate and board information should be presumed. The need for such confidentiality is very strong, not only because disclosure could have harmful effects on the corporation's position in the competitive marketplace, but also because the federal Security and Exchange Commission regulations against insider trading could expose both the corporation and the individual to financial liability.¹¹⁸

A board of directors has many requirements that it must follow. The board must adhere to the many facets of both the duty of care and the duty of loyalty. As will be seen, the Delaware courts have not made the director's job any easier due to their many conflicting decisions. Noting the problems corporate directors encountered in adhering to the varied parameters of the duties of care and loyalty, the Delaware legislature enacted section 102(b)(7) of the Delaware Corporate Code.

II. SECTION 102(b)(7) OF THE DELAWARE GENERAL CORPORATION LAW

Since 1950, a system has developed whereby corporate governance is based on the concept that large public corporations should have a majority of outside, independent directors on their boards.¹¹⁹ Recent courts have given increased emphasis to independent board decisions.¹²⁰ Many courts have even denied the benefit of the business judgment rule to those boards that do not have an independent majority.¹²¹ This encourages shareholders to elect directors who are independent and whose main interest will be in the shareholders they serve. Obviously, this system of outside directors depends upon the willingness of qualified persons to serve on the board.

118. *Id.* See also *Strong v. Repide*, 213 U.S. 419, 420 (1909) (officer may not buy shares of minority shareholder without disclosing special circumstances); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932) (director may not purchase shares from minority shareholder without disclosing material facts); *Ruder*, *supra* note 67, at 1398-99 (common law roots of insider trading doctrine).

119. *Auerbach v. Bennett*, 47 N.Y.2d 619, 625, 393 N.E.2d 994, 997 (1979) (special committee of outside directors); *Barr v. Wachman*, 36 N.Y.2d 371, 374, 329 N.E.2d 180, 183 (1975) (eleven of sixteen outside directors).

120. Problems of "structural bias," however, continue to exist since most directors are either friends of the insider officers or act at the pleasure of the insiders. See *Zapata v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981) (corporation must prove independence and good faith of directors). *But see* *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (discounting structural bias). See also *Dent, Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 Nw. U.L. REV. 96, 111-15 (1980) (difficulty of maintaining independence of outside directors).

121. *Swanson v. Traer*, 249 F.2d 854 (7th Cir. 1957) (stockholder may sue when majority of board is subject to control of corporation); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976) (stockholder must have opportunity to test independence of special committee); *Republic Nat'l Life Ins. Co. v. Beasley*, 73 F.R.D. 658 (S.D.N.Y. 1977) (business judgment rule valid when board of directors is independent and disinterested); *Gilbert v. Curtiss-Wright Corp.*, 179 Misc. 641, 38 N.Y.S.2d 548 (1942) (plaintiff must prove that directors had knowledge of or participated in illegal activities).

In the past few years, however, several factors developed that make it less likely that corporations will be able to attract and retain high caliber outside directors. The first factor was a severe decline in the scope of coverage and the availability of liability insurance to directors and officers.¹²² Secondly, courts were increasingly willing to impose staggering personal liability upon directors for actions that involved breaches of their fiduciary duties to shareholders.¹²³ Finally, these developments occurred when corporations were faced with the increased likelihood of litigation against directors.¹²⁴ Unfortunately, corporations in industries that required the most imaginative leadership could not obtain adequate director and officer insurance coverage.¹²⁵

In 1985, in response to the increasing scarcity of qualified, disinterested directors, the Corporate Law Section of the Delaware State Bar Association formed a committee to develop solutions to alleviate these problems.¹²⁶ The committee first considered legislation that was designed to greatly expand the power of Delaware corporations to indemnify directors and officers.¹²⁷

122. See generally *Ailing Director and Officer Insurance Market Looks for Cure*, BUS. LAW. UPDATE 1 (Mar./Apr. 1986) (citing restrictive cost of director and officer insurance); *Director Insurance Drying Up*, Wall St. J., Mar. 7, 1986, at 1, col. 6 (discussing how insurance companies are getting out of director and officer lines); *Business Struggles to Adapt as Insurance Crisis Spreads*, Wall St. J., Jan. 21, 1986, at 31, col. 4 (discussing how companies are self-insuring); *Insurers Beginning to Refuse Coverage on Directors and Officers in Takeover Cases*, Wall St. J., Jan. 20, 1986, at 3, col. 2 (discussing large judgments against directors found liable in takeover contests); *Liability Insurance is Difficult to Find Now for Directors*, Wall St. J., July 10, 1985, at 10, col. 2 (noting few insurers left in the business).

123. See *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (Trans Union directors personally liable for millions of dollars).

124. See, e.g., *Mesa Petroleum Co. v. Unocal Corp.*, 493 A.2d 946, 949-52 (Del. 1985). The oil industry was going through a tremendous shakeout in 1983-1985. This consolidation, led by Mesa's T. Boone Pickens, made board members of even the largest oil concerns very nervous.

125. See *National Union Fire Ins. Co. v. Seafirst Corp.*, 662 F. Supp. 36 (W.D. Wash. 1986) (\$110 million settlement in action against former directors). See generally Block, Barton & Garfield, *Advising Directors on the Director and Officer Insurance Crisis*, 14 SEC. REG. L.J. 130 (1986); Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399 (1987) (approaches to deal with director's liability); Ahrons, *The Job Nobody Wants*, 2986 BUS. WK. 56 (Sept. 8, 1986); *The Director and Officer Crisis: Corporate Boardroom Woes Grow*, Nat'l L.J., Aug. 4, 1986, at 1, col. 4 (problem of expanding liability in takeover battles).

126. The legislative synopsis, adopted on June 18, 1986, stated:

Section 102(b)(7) and the amendments to Section 145 represent a legislative response to recent changes in the market for directors' liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of traditional policies . . . have threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling to serve without the protection which such insurance provides and may be deterred from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection in various forms to their directors and to limit Director liability in certain circumstances.

LEGISLATIVE SYNOPSIS to S. 533, 133d Del. Gen. Assembly (1986).

127. See S. 533, 133d Del. Gen. Assembly § 2 (1986) and comments thereto.

While certain minor amendments to the indemnification provisions of the statute were retained,¹²⁸ the committee ultimately submitted legislation that

128. Changes were made in section 145 of the Delaware General Corporation Law which governs indemnification of directors, officers, employees, and agents. A synopsis of these changes is as follows:

Section 145(b), as in effect prior to the new amendments, required court approval before there could be any indemnification for expenses incurred in derivative actions where the defendant had been found liable 'for negligence or misconduct in the performance of his duty' (DEL. CODE ANN. tit. 8, § 145(b)). The amendments dropped the quoted language in order to make the statute consistent with the decisions of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), to the effect that directors are liable only for gross negligence where violations of their duty of care are alleged. The amendments do not alter the requirement for court approval before indemnification for expenses may be had in derivative suits which have resulted in an adjudication of liability.

Section 145(e) authorizes a corporation to advance litigation expenses to an officer or director prior to the final disposition of an action. This section conditions the making of such advances upon the defendant giving the corporation an undertaking to repay if it turns out that indemnification is not available. The 1986 amendments change the form of the director's or officer's undertaking from a promise to repay 'unless it shall ultimately be determined that he is entitled to be indemnified' to a promise to repay 'if it shall ultimately be determined that he is not entitled to be indemnified.'

This change shifts the burden of going forward to obtain the required finding as to entitlement to indemnification from the claimant to the corporation. While the amendment may make signing the undertaking more palatable, its effect is more symbolic than real since the statute continues to require, at Section 145(d), that indemnification be authorized pursuant to a finding that the indemnitee has met the statutory standard. Hence, the board, by a majority of disinterested directors, the stockholders, or, as the statute permits, independent legal counsel, will still have to decide whether indemnification is warranted in each case.

A more substantive change in Section 145(e) is reflected in the 1986 amendments' deletion of the requirement that advances of litigation expenses be 'as authorized by the board of directors in the specific case.' The quoted language, which has been eliminated, suggested that directors must evaluate each request for an advance on an individual basis. This raised questions as to the validity of charter or by-law provisions, or individual contracts of indemnification, which purport to obligate the corporation to make advances whenever an officer or director proffers an undertaking in proper form. The deletion of the quoted language facilitates such a general authorization.

Section 145(f) of the General Corporation Law states that the indemnification authorized by Section 145 is not exclusive of any other rights to indemnification which a director, officer, employee or agent may have under a by-law, agreement, board or stockholder resolution 'or otherwise.' This non-exclusive feature of the Delaware statute and other state statutes modelled on it contrasts sharply with state indemnification statutes which expressly limit permissible indemnification to that provided in the statute. The scope and intent of the non-exclusive language of Section 145(f) has been much debated. In recent times, because of the shrinking availability and coverage of liability insurance, corporations have looked to this provision as a basis for granting more expansive indemnification. Where directors' and officers' liability coverage has been cancelled or becomes too expensive, or

permitted shareholders to limit liability if they so chose.¹²⁹ Such a limitation is analogous to principles of trust law which contemplate that beneficiaries may agree to limit the liability of trustees.¹³⁰ The State Bar Association theorized that an amendment of this type would be a more direct approach and would fit well within the traditional enabling character of section 102.¹³¹ The Delaware legislature adopted verbatim the 1986 amendments that the Corporate Law Section proposed. The new law, section 102(b)(7), became effective on July 1, 1986.¹³²

Section 102 of the Delaware General Corporation Law sets forth what is to be included in a certificate of incorporation.¹³³ While section 102(a)

where new exclusions in the insurance contract make its value questionable, corporate lawyers have tried to formulate charter and by-law provisions and individual contracts of indemnification which will substitute for the insurance in whole or in part.

The 1986 amendments do not elucidate the scope of the non-exclusive language of Section 145(f). However, they do make it clear that advances of expenses are meant to be included within the non-exclusivity concept so that a director's or officer's right to have his litigation expenses paid by the corporation in advance of the disposition of the proceeding may be expanded and other rights relating thereto may be granted by a by-law provision or contract so long as no public policy is offended.

The 1986 amendments also change Section 145(f) by moving to a new Section 145(j) language indicating that the indemnification provided by the statute continues as to a person who ceases to be a director, officer, employee or agent and inures to the benefit of his heirs, executors and administrators. It was thought that this provision should be in a free-standing subsection of Section 145 since it relates to the entire section. No substantial change was intended.

LEGISLATIVE SYNOPSIS to S. 533, 133d Del. Gen. Assembly (1986). *See also* Letters from Black, Sparks & Johnston, partners at the firm of Morris, Nichols, Arsht & Tunel to their clients (May 7, 1986 and June 18, 1986) (explaining amendments).

129. DEL. CODE ANN. tit. 8, § 102(b)(7) (1986).

130. *See* RESTATEMENT (SECOND) OF TRUSTS § 222 (1959). Possibly, the certificate of incorporation of Delaware corporations could have been amended to limit or eliminate liability of directors without enabling legislation under pre-existing law, by analogizing to trust law as set forth in an old English Chancery decision, *In re Brazilian Rubber Plantations & Estates, Ltd.*, 1 Ch. 425 (1911), which appears to sanction a corporation charter provision limiting liability. *See also* Directors Liability Act of 1890, 53 & 54 VICT. 516, 517, Ch. 64 (1890) (limiting directors' liability for statements made in prospectus); *Derry v. Peek*, 14 H.L.(E) 337 (1889) (directors not personally liable for misstatements in prospectus). The Directors Liability Act was passed in response to *Derry v. Peek*. For a modern English version, see *Viscount of the Royal Count of Jersey v. Barry Shelton*, 1 W.L.R. 985, 986 (1986) (insulating directors from liability for negligent acts).

131. *See* S. 533, 133d Del. Gen. Assembly (1986) and supporting comments.

132. *Id.*

133. The new section 102(b)(7) states as follows:

In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: . . . (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision

identifies what a company must include in its certificate of incorporation, it is only an enabling provision. Generally, section 102(b)(7) provides companies with the option of including a provision in the certificate of incorporation that is intended to limit the directors' exposure to personal monetary liability.¹³⁴ To achieve the protection that the new legislation authorizes, a corporation must either amend its certificate of incorporation to add the liability-limiting provision, or include such a provision in its original certificate of incorporation.¹³⁵ By the terms of the statute, any provision so adopted will have a prospective effect only, and will not eliminate or limit the liability of a director for any act or omission that occurs prior to its adoption.¹³⁶

The statute specifically states that a corporation may not eliminate or limit the liability of its directors in all situations. Directors will always be liable for: a) breaches of their duty of loyalty, b) acts or omissions in bad faith, c) acts involving intentional misconduct or knowing violations of law, d) violations of section 174 of the General Corporation Law,¹³⁷ or e) any

shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under sec. 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in the paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

DEL. CODE ANN. tit. 8, § 102(b)(7) (1986).

134. *Id.*

135. In order to amend its certificate of incorporation, a Delaware corporation must follow section 242(b)(1) which states:

(1) If the corporation has capital stock, its board of directors shall adopt a resolution setting forth the amendment proposed, declaring its advisability, and either calling a special meeting of the stockholders entitled to vote in respect thereof for the consideration of such amendment or directing that the amendment proposed be considered at the next annual meeting of the stockholders. . . . If a majority of the outstanding stock entitled to vote thereon, and a majority of the outstanding stock of each class entitled to vote thereon as a class has been voted in favor of the amendment, a certificate setting forth the amendment and certifying that such amendment has been duly adopted in accordance with this section shall be executed, acknowledged, filed, and recorded,

DEL. CODE ANN. tit. 8, § 242(b)(1) (1953).

136. *See supra* note 133 and accompanying text.

137. Section 174 holds Delaware corporate directors liable for improper payment of dividends or improper stock purchases or redemptions. The text of section 174 is as follows:

(a) In case of any wilful or negligent violation of sec. 160 or 173 of this title, the directors under whose administration the same may happen shall be jointly and severally liable, at any time within 6 years after paying such unlawful dividend if after such unlawful stock purchase or redemption, to the corporation, and to its creditors in the event of its dissolution or insolvency, to the full amount of the dividend unlawfully paid, or to the full amount unlawfully paid for the purchase or redemption of the corporation's stock, with interest from the time such liability accrued

DEL. CODE ANN. tit. 8, § 174(a) (1953).

transaction from which the director derives an improper personal benefit.¹³⁸ In essence, the new legislation permits a corporation to protect its directors from monetary liability for duty of care violations alone.

Nevertheless, although not explicitly stated, section 102(b)(7) does not completely eliminate the duty of care imposed on directors. Directors continue to have fiduciary duties in the decision-making process and in their oversight responsibilities. For example, the duty of care continues to be vitally important in injunction and rescission cases, and may be relevant in other contexts.¹³⁹ The statute simply allows a cap to be placed on directors' personal monetary liability.

In more general terms, implementation of section 102(b)(7) allows a charter provision to be written broadly to provide that directors are not liable to the corporation or its shareholders for breaches of their fiduciary duties except as otherwise required by the law. It could also impose specific limitations on such liability. Accordingly, the new section could be viewed as a cap on directors' liability that may take the form of a stated maximum dollar amount for which directors may be liable, either individually or collectively. Other limitations also could be imposed such as conditioning the relief from liability on directors taking specific action¹⁴⁰ or limiting liability in connection with certain specific matters.¹⁴¹

138. See *supra* note 133.

139. Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947) (fiduciary relationship with stockholders); Edelman v. Fruehauf Corp., Fed. Sec. L. Rep. (CCH) § 92,863 (6th Cir. 1986) (defendants enjoined from pursuing tender offer). *But cf.* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (explores target manager's duty).

140. Some commentators have suggested that the new legislation exempts directors from liability for reckless actions that fall between ordinary negligence and intentional wrongdoing. See Wiggins, *Delaware Director and Officer Liability Law, A "Windfall" for Directors*, Legal Times, Aug. 18, 1986, at 11, col. 1 (criticizing statute). *But see* Sparks, *Delaware's Director and Officer Liability Law: Other Statutes Should Follow Suit*, Legal Times, Aug. 18, 1986, at 10, col. 4 (supporting statute). Exactly what the statute protects in this context is not altogether clear. *Id.* If one includes a conscious disregard of a known risk in the definition of recklessness, this might be a breach of good faith and liability flowing therefrom would not be exempt under the statute. If, however, one only includes inattention in the definition of recklessness, it could possibly amount to gross negligence, but not conduct amounting to bad faith, and hence be protected conduct. See Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (1961) (non-affiliated directors of mutual fund who were grossly negligent in failing to discover illegal transactions were liable for losses even though they acted in good faith). *But see* Kelly v. Bell, 266 A.2d 878 (Del. 1970) (business judgment rule protects directors as long as decision made in good faith); Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963) (directors must use amount of care that prudent men would use in similar circumstances).

141. See Letters from Black, Sparks & Johnston, partners at the firm of Morris, Nichols, Arsht & Tunnell, to their clients (May 7, 1986). These letters also suggested that actual amendments to certificates of incorporation would be of two types; one, which used the statutory language verbatim, or a second, which incorporated the statute by reference and read somewhat like this: "To the fullest extent permitted by Section 102(b)(7) of the D.G.C.L. [Delaware General Corporation Law] as the same exists or may hereafter be amended, a director of the corporation shall not be liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director." *Id.*

Section 102(b)(7) authorizes limiting or eliminating monetary liability only for directors who act in the capacity of directors.¹⁴² It does not limit the liability of a director for acts or omissions in a capacity other than as a director.¹⁴³ It does not apply to officers, employees, or agents except that one who is a director and an officer may be limited to liability for acts done in a directorial capacity. In the case of a director-officer, actions taken solely in the capacity of an officer cannot be exempt from liability.¹⁴⁴

The Delaware legislature has taken a much needed step toward protecting directors of its corporations.¹⁴⁵ Under prior law, the absence of a provision such as section 102(b)(7) prevented shareholders from protecting their directors from unlimited personal liability. Directors previously were held to a common law fiduciary standard over which shareholders had no control.¹⁴⁶ Under the common law principles, directors and shareholders had no means of limiting the directors' liability. Eventually, the costs of fulfilling directorial roles outweighed the benefits for many qualified individuals. If competent directors are unwilling to serve because of an unreasonable risk of exposure to their personal assets, the laudable policy of having independent directors is seriously undermined. The true impact of section 102(b)(7), however, is yet to be seen. The interpretation of the terminology in this section has been left open for the judiciary. As the courts provide clearer definitions of the duties of care and loyalty, one will be able to better predict the amendment's impact on a corporation's ability to recruit qualified, independent directors.

III. IMPACT

This section will attempt to point out potential problems in the actual workings of the new Delaware statute. These problems are seen most easily in a corporate takeover context. Therefore, major decisions in the Delaware Supreme Court¹⁴⁷ and the Second Circuit Court of Appeals concerning corporate takeovers will be presented.¹⁴⁸ The cases will show the respective courts' reasoning and how such analysis might differ under the new law. Since the Delaware legislature wrote section 102(b)(7) in general terms, future courts may be forced to take an active role in deciding how to construe the law.

In spite of the provisions of section 102(b)(7), the statute does not foreclose shareholders who wish to establish that their directors breached their fiduciary duties. Basically, the new law allows a corporation's shareholders to limit the personal liability of their directors for breaches of the duty of

142. See *supra* note 133.

143. *Id.*

144. *Id.*

145. Forty-eight percent of the Fortune 500 companies are incorporated in Delaware. Addams, *The Fortune 500*, *Fortune*, June 21, 1987, at 47.

146. See *supra*, note 62.

147. *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

148. *Hanson Trust PLC v. ML SCM Acquisitions, Inc.*, 781 F.2d 264 (2d Cir. 1986).

care.¹⁴⁹ At the same time, however, the new law expressly forbids placement of a limitation on liability for breaches of a director's duty of loyalty.¹⁵⁰ If a shareholder of a Delaware corporation, which has adopted a provision such as section 102(b)(7), files suit against a director of the corporation, the suit should be phrased in terms of the duty of loyalty rather than broad fiduciary duty or duty of care allegations.

The effectiveness of section 102(b)(7) appears hindered because courts seem confused when differentiating between a breach of the duty of care and a breach of the duty of loyalty. Courts in general, and the Delaware Supreme Court in particular, are hard-pressed to define a breach of the duty of care and/or the duty of loyalty.¹⁵¹ Courts often call the breach a duty of care violation and then support it with a duty of loyalty analysis or vice versa.¹⁵² Until these duties are delineated, section 102(b)(7) will have little effect.

In order to demonstrate the weaknesses of section 102(b)(7), two different takeover situations will be examined. In using the takeover context, one can see how a board of directors is subject to intense pressure to make fast and difficult decisions, and how outside considerations taint such decisions. First, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹⁵³ shows how the Delaware Supreme Court confused the two types of fiduciary duties. The significance of this confusion is that under the *Revlon* court's analysis, if a board of directors that has adopted a provision akin to 102(b)(7) finds itself in a pressure takeover situation, the board is not protected in many instances. Since duty of care breaches are exempt while duty of loyalty breaches are not, the protection section 102(b)(7) provides is ineffective if a court confuses the two duties.

A. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*

In a takeover scenario such as *Revlon*, the business judgment rule is applicable. Therefore, the actions *Revlon*'s board of directors took to thwart the takeover attempt by *Pantry Pride, Inc.* remain subject to the duties of loyalty and care.¹⁵⁴ In summarizing the steps *Revlon*'s directors took in

149. DEL. CODE ANN. tit. 8, § 102(b)(7) (1986).

150. *Id.*

151. *See Revlon*, 506 A.2d 173 (Del. 1986).

152. *Id.*

153. 506 A.2d 173 (Del. 1986).

154. *Revlon*, 506 A.2d at 180. Of the fourteen *Revlon* board members, six held senior management positions, two others held significant blocks of stock, and four others were associated at some point with several entities that had business relationships with *Revlon*. The court further mentioned that, "[O]n the basis of this limited record, however, we cannot conclude that this board is entitled to certain presumptions that generally attach to the decisions of a board whose majority consists of truly outside, independent directors." *Id.* at 176 n.3. *See also Polk v. Good*, 507 A.2d 531, 537 (Del. 1986) (ten out of thirteen outside directors made plaintiff's burden heavy); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del.

response to Pantry Pride's acquisition efforts,¹⁵⁵ one can identify those actions taken before and after the break up of Revlon became inevitable. This distinction is important because under the *Unocal* standards,¹⁵⁶ the directors' role changes at this point from one of fulfilling the duty of defending the corporate entity to the duty of getting the highest bid for the shareholders.¹⁵⁷

Before the breakup became inevitable, Revlon attempted various anti-takeover tactics. In 1985, Revlon's board of directors reacted to Pantry Pride's acquisition proposals, which Revlon considered grossly inadequate, by adopting two plans. In the first plan, the company would repurchase up to five million of its thirty million outstanding shares.¹⁵⁸ The second plan allowed each shareholder to receive a Note Purchase Right (Right) for each share of common stock which entitled the holder to exchange one common share for a \$65 principal Revlon note, to mature in one year at 12% interest. These Rights became effective whenever anyone acquired beneficial ownership of 20% or more of Revlon's shares, unless the purchaser acquired all of Revlon's stock for \$65 or more per share.¹⁵⁹ These Rights would not be available to an acquiror. Also, prior to the 20% trigger event, the Revlon board could redeem the Rights for 10 cents each. Revlon's board unanimously adopted both proposals.¹⁶⁰

The board advised shareholders to reject Pantry Pride's subsequent offer¹⁶¹ and launched its own offer for up to ten million shares. It proposed to exchange one senior subordinated note (Note) of \$47.50 principal at 11.75% interest, due in 1995, and one-tenth of a share of \$9 cumulative convertible exchangeable preferred stock valued at \$100 per share for each common share tendered. Revlon stockholders tendered 87% of all outstanding shares¹⁶² and the company accepted the full ten million shares on a pro rata basis.

When the court reviewed the board's two plans, it noted that the board had protected the shareholders from a hostile takeover at a price below the company's intrinsic value, while retaining sufficient flexibility to address any proposal deemed to be in the stockholders' best interests.¹⁶³ To that extent,

1985) (majority of the board were outside, independent directors which shifted burden of persuasion to plaintiffs); *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) (evaluating "the care, attention and sense of individual responsibility to performance of one's duties [to determine] independence"); *Puma v. Marriott*, 283 A.2d 693, 694 (Del. Ch. 1971) (majority of independent directors, consisting of four inside directors and five outside directors).

155. The plaintiff, MacAndrews & Forbes Holdings, Inc. was Pantry Pride's controlling shareholder. *Revlon*, 506 A.2d at 173 n.1.

156. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).

157. *Revlon*, 506 A.2d at 177.

158. *Id.* at 177.

159. *Id.*

160. *Id.*

161. *Id.*

162. Approximately thirty-three million shares were outstanding at this time. *Id.*

163. *Id.* at 181.

the board acted in good faith and upon reasonable investigation.¹⁶⁴

Meanwhile, as Pantry Pride continued to increase the value of its cash bids, Revlon undoubtedly recognized that it would be broken up. The actions of the Revlon board after this point were subject to scrutiny because of the shift in emphasis of the board's duties from protecting the corporate entity to maximizing the value that the shareholders would receive in a takeover. First, Forstmann, Little & Co. ("Forstmann") offered a leveraged buyout and the board unanimously agreed. The Forstmann agreement included a payment of \$56 cash for each share outstanding and the assumption of Revlon's \$475 million debt incurred when it issued the Notes.¹⁶⁵ Revlon, in turn, would redeem the Rights and waive the Notes covenants for Forstmann or for a higher offer by a third party. The announcement of this agreement caused the market price of the Revlon securities to plummet.¹⁶⁶

Second, as Pantry Pride continued to increase the value of its cash bids, Revlon's board entered into a lockup option¹⁶⁷ with Forstmann. Under the agreement, Forstmann would purchase Revlon's Vision Care and National Health Labs¹⁶⁸ if another aggressor obtained 40% of Revlon's shares. Revlon was required to accept a no-shop provision,¹⁶⁹ to remove the Rights and Notes covenants, and to place a \$25 million cancellation fee in escrow.¹⁷⁰ This fee would be released to Forstmann if the agreement was terminated or if another acquiror obtained more than 19.9% of Revlon's stock. Forst-

164. *Id.*

165. The parties were not negotiating on an equal basis since Forstmann was privy to certain Revlon financial data at that point, to Pantry Pride's exclusion. *Id.* at 178.

166. *Id.*

167. A "lockup option" is an arrangement by which the target corporation in a takeover contest gives one proposed acquiror a competitive advantage over other bidders. Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1068-69 (1983). Usually, it involves granting the favored suitor (the "White Knight") an option to purchase the "crown jewels" of the company (most productive or profitable divisions) at below-market rates. The option is usually triggered if the aggressor buys more than a certain percentage of the target. The aggressor is presumably after the target in order to gain the benefits of these "crown jewels" which will no longer be a part of the target. These are also known as "scorched earth" tactics. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986) (granting Merrill Lynch option to buy profitable pigments division). See also *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981) (lockups constitute a "manipulative" device under the Williams Act). *But see Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983) (holding *Mobil* to be unwarranted extension of Williams Act), *cert. denied*, 465 U.S. 1062 (1984). For a more detailed analysis of lockup options, see *Fraidin & Franco, Lock-Up Arrangements*, 14 REV. SEC. REG. 821 (1981); Nathan, *Lock-Ups and Leg-Ups: The Search for Security in the Acquisitions Marketplace*, 13 INST. ON SEC. REG. 1, 4 (1982); Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068 (1983).

168. Lazard Freres, Revlon's investment bankers, ascribed to the divisions a value approximately \$100-175 million above the purchase price. *Revlon*, 506 A.2d at 178.

169. The "no-shop" provision prevented the board of directors from searching for competing, higher bids. *Id.*

170. *Id.*

mann, in return, agreed to support the par value of the Notes by an exchange of new notes.¹⁷¹

Pantry Pride then took its battle from Wall Street to the courtrooms of Delaware. Pantry Pride filed an amended complaint that challenged the lockup, the cancellation fee, and the exercise of the Rights and Notes covenants.¹⁷² Pantry Pride also sought a temporary restraining order to prevent Revlon from placing any assets in escrow or transferring them to Forstmann.¹⁷³ In holding for Pantry Pride, the trial court concluded that Revlon's directors breached their duty of loyalty by making concessions to Forstmann out of their concern for their personal liability to Noteholders, rather than maximizing the sale price of the company for the shareholders' benefit.¹⁷⁴

Revlon appealed this ruling to the Delaware Supreme Court. In reviewing the board of director's actions, the supreme court first noted that when operating in a takeover context, due to the "omnipresent specter" that a board may put its own interests before those of the corporation or its shareholders, "an enhanced duty exists which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."¹⁷⁵ The court explained that this test is satisfied when the directors show that the defensive measures are implemented with a proper corporate purpose¹⁷⁶ and that such measures are reasonable in relation to the threat posed.¹⁷⁷

The court essentially split the entire transaction into two main categories consisting of: (1) Revlon's self-tender and the Notes and the Rights plans;¹⁷⁸ and (2) the lockup option, the no-shop provision, and the cancellation fee. The court found the first group of transactions to have a valid corporate purpose.¹⁷⁹ This is not surprising since a board of directors can usually find

171. 506 A.2d at 178-79.

172. 506 A.2d at 179.

173. *Id.*

174. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1250 (Del. Ch. 1985). *But cf.* *Revlon, Inc., v. Pantry Pride, Inc.*, 621 F. Supp. 804 (D.C. Del. 1985) (TRO denied because target failed to show likelihood of success).

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

176. *Revlon*, 506 A.2d at 180.

177. *Id.* Whether the court refined the *Unocal* test or only discussed the first step necessary to receive protection under the business judgment rule remains unclear. No board may receive the protection of the business judgment rule if it undertakes actions that the corporation has not authorized. *Id.*

178. The court characterized the Rights plan as a "poison pill." A poison pill defense consists of a target company's declaration of a dividend of convertible preferred stock to its shareholders. Since this stock automatically becomes the successor's stock in a merger, and convertible into that company's voting stock, it dilutes the control of the aggressor. *See Dawson, Pence & Stone, Poison Pill Defensive Measures*, 42 *Bus. Law.* 423 (1987). One study showed that ten out of thirty-seven companies adopting poison pills experienced a change in control soon thereafter. Office of the Chief Economist of the SEC, *A Study on the Economics of Poison Pills*, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 83,971 (Mar. 5, 1986).

179. *Revlon*, 506 A.2d at 181.

an investment bank that will value the company at a higher figure than the current market price. In this situation, the board could also assert that it was maximizing shareholder value. The court found these measures to be reasonable in relation to the threat posed, since Pantry Pride increased its offers in response to the board's actions.¹⁸⁰

The court, however, reasoned that the second set of defensive measures were not undertaken for a proper corporate purpose since the board of directors knew, or should have known, that the company was going to be sold.¹⁸¹ At this time, the "directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the shareholders."¹⁸² These moves also were unreasonable in relation to the threat posed in that, rather than spurring the bidding to new heights, they effectively ceased the process.¹⁸³

The court then proceeded to discuss the specifics of the lockup option between Revlon and Forstmann. The board's alleged rationale for granting this option was to shore up the value of the Notes because it also owed a duty to the Noteholders. The court rejected this reasoning and held that the duties owed to the Noteholders were fixed by contract.¹⁸⁴ The duties owed to the shareholders, by contrast, should have been first and foremost, and by neglecting them, the board breached its primary duty of loyalty.¹⁸⁵ The court then stated that "[T]he principal object, contrary to the board's duty of care, appears to have been the protection of the noteholders' over the shareholders' interests."¹⁸⁶

Thus, Revlon's directors apparently breached both their duty of care and their duty of loyalty.¹⁸⁷ The meaning of the *Revlon* court's decision, however, is unclear. The court argued that the Revlon board was more concerned with its potential liability to Noteholders, due to the decrease in market value, than with its duties to shareholders. In doing so, the court used what appears to be a duty of loyalty analysis (without the fairness component) to show that the directors put their own interests above those of the corporation.

By arguing that the board should have recognized the imminent fall of Revlon and thus sought the highest price for the shareholders' stock, the court used an analysis that appears on its face to be a duty of care analysis. Exactly which duty the board breached, however, is difficult to determine. The relevant inquiry is whether the Revlon directors would have been protected (due to a duty of care breach) or not (due to a duty of loyalty breach) if they had adopted a provision pursuant to section 102(b)(7).

180. *Id.*

181. *Id.* at 182.

182. *Id.*

183. *Id.* at 183.

184. *Id.* at 182.

185. *Id.* at 183-84.

186. *Id.* at 184.

187. *Id.* at 181-84.

The duty of loyalty analysis in *Revlon* may be dicta since the decision centers on the illegality of the particular crown jewel lockup option.¹⁸⁸ The lockup basically had no relation to the Notes or the directors' liability to the holders of those Notes. Therefore, even without the Noteholder versus shareholder analysis, in all likelihood the board still would be liable. The liability would have been based on the board's failure to act as auctioneer and obtain the best deal for the shareholders.

Since the court's Noteholder analysis is akin to a duty of loyalty analysis and is not relevant to the outcome, the question remains as to what basis the court actually uses to hold the directors liable. In deciding that the crown jewel lockup option was illegal in this case, the court again focused on the purpose and reasonableness factors. But it did so in a manner that was not the traditional duty of care analysis.

If the *Revlon* court intended a director's duty of care to include all of the factors mentioned above except self-dealing, which then will be the only component left in a duty of loyalty analysis, it is simply a duty of care case. The reason for this confusion is that the Delaware Supreme Court, in its analysis of the breaches that occurred, included both traditional duty of care and duty of loyalty concepts. If *Revlon* had adopted section 102(b)(7), the directors could not have been held personally liable because the court never expressly stated which duty the directors breached. Without such direction from the court, the statute is impotent because it can absolve a director's duty of care violations but is powerless against a director's breach of the duty of loyalty. If a court uses any analysis and yet calls it a loyalty analysis, directors who have adopted section 102(b)(7) will be unscathed regardless of their conduct.

If, on the other hand, the *Revlon* court intended a director's duty of care to include all of the factors in the traditional business judgment rule, then *Revlon* is not decided on either a duty of care or a duty of loyalty basis. Rather, it is decided by independent judicial determination. In the future, the corporate purpose portion of this new test might be fairly easy for a board of directors to prove.¹⁸⁹ In light of *Revlon*, therefore, judicial deference to the board probably would still exist here. However, the *Revlon* court independently decided which measures were "reasonable in relation to the threat posed." When deciding if the board's defensive tactics were reasonable in relation to the threat posed, the *Revlon* court was engaged in what appeared to be a "smell test." In other words, the court responded to its gut reaction to the *Revlon* board's actions. This, obviously, is neither a duty of care analysis nor a duty of loyalty analysis, but a case of independent judicial determination.

188. See *supra* notes 149-50.

189. Boards have often maintained that a shift in the financial makeup of the balance sheet is necessary and it has proved to be an impossible task to prove them wrong. Dawson, Pence & Stone, *Poison Pill Defensive Measures*, 42 Bus. Law. 423, 425 (1987).

The Delaware legislature appears to have drafted the statute ambiguously to allow the judiciary to decide the specific parameters of directors' duties.¹⁹⁰ Since most takeover decisions are mixed-motive decisions, they arguably contain breaches of both the directors' duties of care and of loyalty. In light of *Revlon*, it does not matter whether a shareholder or a rejected suitor files suit against the corporation claiming a breach of a duty of care or loyalty. The exact requirements of either of the duties are so malleable that one could still sue under the *Revlon* facts and courts could then hold the directors liable. Thus, in many situations, section 102(b)(7) does nothing to remove the personal liability of a corporation's directors.

*B. Hanson Trust PLC v. ML SCM Acquisition, Inc.*¹⁹¹

Like *Revlon*, *Hanson* is also set in a takeover context. Although the Second Circuit Court of Appeals decided the case, the facts again demonstrate the confusion between a duty of care and a duty of loyalty.

Hanson initiated a series of takeover tactics when it made an all-cash offer for SCM. SCM and its white knight,¹⁹² Merrill Lynch Capital Markets, countered with a part-cash, part-debenture¹⁹³ offer.¹⁹⁴ In countering, the SCM board granted a crown jewel lockup option¹⁹⁵ to Merrill which provided that if any other party (in this case, Hanson) acquired more than one-third of all SCM shares, Merrill would have the right to buy SCM's two most profitable businesses.¹⁹⁶ Hanson then cancelled its tender offer and began to purchase shares in the open market, which triggered Merrill's option to

190. The Delaware legislature appears to be mostly blue-collar. Section 102(b)(7)'s main Senatorial sponsor was a steel-worker by trade. The Delaware legislature gives great deference to the Delaware corporate bar which appears to be made up of a small number of Wilmington and Dover law firms. In passing 102(b)(7), the Delaware legislative council librarian informed this author that after a draft of the amendment was submitted by the Delaware State Bar Association, the following sequence of events occurred: on day one the Senate debated the draft for ten minutes; on day two the House debated it for five minutes; and on day three the governor signed it into law. Telephone interview with Lynn Goldberg, Delaware Legislative Council Librarian (Jan. 1987).

191. 781 F.2d 264 (2d Cir. 1986). See also *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985) in which Hanson's termination of a tender offer and immediate purchase of large blocks of SCM stock did not violate the Williams Act, 15 U.S.C. §§ 78n(d)(1), (6) (1982).

192. See *supra* note 166.

193. A debenture is a bond backed by the general credit of a corporation and usually is not secured by a mortgage or lien on any specific property. BLACK'S LAW DICTIONARY 361 (5th ed. 1979).

194. 781 F.2d at 267.

195. See *supra* note 166.

196. 781 F.2d at 267. Merrill Lynch had an option to purchase the Pigments and Consumer Foods divisions for \$350 million and \$80 million, respectively. Crown jewel lockup options traditionally price the most profitable divisions at bargain basement prices. SCM appears to be no different. There is evidence that Goldman Sachs & Co., SCM's investment bankers, thought these prices were at the very bottom of a range of fair prices. *Id.* at 275.

buy.¹⁹⁷ After Merrill's announcement that it would exercise the option, Hanson announced a new tender offer and filed suit claiming that the business judgment rule did not protect the SCM board's approval of the lockup option, which was a breach of its fiduciary duties to the shareholders.¹⁹⁸

The *Hanson* court began its analysis by presuming that the case involved a duty of care.¹⁹⁹ The court did not even consider that the management buyout, in response to the takeover threat, might present conflicts of interest and, therefore, a breach of the duty of loyalty. However, while expressly stating that this was a duty of care case, the court specified that the actions of the SCM board did not rise to a level of gross negligence.²⁰⁰ The court, therefore, implied that if SCM's board was only negligent, as opposed to grossly negligent, the board still would have breached its duty of care.²⁰¹

SCM's shortfall, according to the court, was that the directors held a three hour, late night meeting where they contented themselves with their financial advisor's conclusionary opinion that the lockup option prices were "within the range of fair value."²⁰² Had the directors inquired further, they would have learned that the advisor had not even calculated a range of fairness.²⁰³ Moreover, the board never asked what the top value was, or why two businesses that generated half of SCM's income were being sold for one-third of the total purchase price of the company under the second leveraged buyout agreement.²⁰⁴

If this was truly a duty of care case, as the court stated,²⁰⁵ it should have deferred to the board's decisions under the business judgment rule. The court could easily have found a proper business purpose. The leveraged buyout and lockup option arguably also were related to the threat posed, but the court did not give deference to SCM's board. Instead, the court discussed the board's failure to look into ranges of reasonableness, fairness

197. See *Hanson Trust PLC v. SCM Corp.*, 774 F.2d at 52-54. Within hours following this announcement, Hanson purchased approximately 25% of SCM's common stock from arbitrageurs and institutions. *Id.* at 52. Later that day, Hanson increased its holdings to over 37%. *Id.* at 53.

198. 781 F.2d at 272.

199. *Id.* at 273. See also *Norlin Corp. v. Rooney Pace*, 744 F.2d 255, 264-65 (2d Cir. 1984) (presumption of propriety inures to benefit of directors).

200. See *supra* note 128 and accompanying text. See also *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (board's approval of amendments to cash-out merger proposal deemed gross negligence due, in part, to failure to consider valuation information reasonably available).

201. See *supra* note 128 and accompanying text discussing the negligence and gross negligence standards.

202. *Hanson Trust PLC v. SCM Acquisitions, Inc.*, 781 F.2d at 275.

203. Goldman Sachs offered no written opinion as to the value of the two optioned divisions. *Id.*

204. *Id.*

205. *Id.*

of prices, and fairness to stockholders.²⁰⁶ Essentially, the court engaged in a duty of loyalty analysis.²⁰⁷

The significance of *Hanson* lies in the court's confusion as to the duties of care and loyalty. If SCM had adopted an article akin to Delaware's section 102(b)(7), the outcome might have been different. If the court chose to call what appears to be a duty of loyalty analysis a duty of care analysis, the directors of SCM might not have been personally liable because section 102(b)(7) exempts directors from duty of care violations and not from duty of loyalty violations. On the other hand, even if the court went through a full scale duty of care analysis, the directors might still be personally liable for breaches of their duty of loyalty, which is not protected by section 102(b)(7). In other words, even if the *Hanson* court had gone through the purpose and reasonableness prongs of the care analysis, SCM's directors could still be found liable for unfairness and conflicts of interest under a loyalty analysis.²⁰⁸

C. What Lies Ahead for Directors' Liability?

The Delaware legislature seems to have written section 102(b)(7) so that courts could use as much latitude as possible. As the analysis of both *Revlon* and *Hanson* attempts to demonstrate, interpretation of the new section will not be an easy task for the courts. If courts correctly define both the duty of care and the duty of loyalty analyses and proceed to apply them consis-

206. *Id.*

207. *See supra* notes 76-118 and accompanying text.

208. In order to demonstrate a situation where the new section 102(b)(7) should work exactly as planned, one would be required to find a pure duty of care case. The celebrated case of *Smith v. Van Gorkom* is probably the closest case. 488 A.2d 858 (Del. 1985). *Van Gorkom* involved Marmon Group's leveraged buyout of Trans Union Corporation. Trans Union's board consisted of ten directors, five of whom were "insiders." *Id.* at 868. While they were all very well informed about the company, none were investment bankers or financial analysts. *Id.*

The board convened a special meeting to consider the terms of the buyout, which lasted only two hours. *Id.* at 869. The company's investment bankers were not invited. During the meeting, no financial analysis or fairness advice on the proposed \$55 price-per-share offer were given. Indeed, no valuation study had ever been made. *Id.* Trans Union's Chief Executive Officer (*Van Gorkom*), had determined the price solely on his own and the methodology by which he arrived at this figure was never disclosed to the rest of the board at the meeting. Moreover, the directors never received any documentation concerning the proposed merger or the adequacy of the price. *Id.* at 874-75. Despite this lack of information, the directors approved the terms of the buyout, and the merger agreement was thereafter executed by the CEO, who had never actually read the legal documents.

In finding both the "inside" as well as the "outside" directors liable for a breach of the duty of care, the court used a "pure" business judgment rule analysis (purpose and reasonableness). The Delaware Supreme Court held that considerations of good faith are irrelevant in determining the threshold issue of whether or not the directors as a board exercised an informed business judgment. *Id.* at 890. The fact that a bidder has imposed a time limit will not excuse uninformed board action. If, in a rare case, a court uses a straightforward business judgment rule analysis of the duty of care, the statute will prevent directors' personal liability.

tently, the consequences of a director's actions will be much more predictable. Directors whose shareholders have adopted provisions similar to section 102(b)(7) will not only know where and how they will be held liable for their actions, but they also will know how to react in given situations. Directors will know that all courts expect a proper purpose for defensive actions the board takes, and they will know that all courts expect the board's actions to be reasonable in relation to the threat posed, which conforms to the traditional duty of care analysis. Finally, they will know what constitutes fairness and conflicting interests, factors encompassed in the traditional duty of loyalty analysis. Unless courts adopt consistent standards to complement section 102(b)(7), many boards in situations similar to those of the Revlon or Hanson boards, will not know how to defend those to whom they owe their greatest duties.

In order to give the greatest guidance to directors, courts should specifically adopt the Revised Model Business Corporation Act's definition of duty of care²⁰⁹ as well as the purpose and reasonableness components expressed in *Revlon*.²¹⁰ Courts also should adopt the *Corporate Director's Guidebook*²¹¹ definition of loyalty that includes conflicts of interest, fairness, corporate opportunities, and confidentiality. Finally, the Delaware legislature should reconsider its almost complete deference to the courts and adopt some definitional statutes to aid the courts.

Since many of our nation's largest corporations are incorporated in Delaware,²¹² they will have an opportunity to adopt an article under section 102(b)(7).²¹³ Also, some non-Delaware corporations will likely reincorporate in Delaware to take advantage of the new protection offered.²¹⁴ For this reason alone, courts should carefully use section 102(b)(7) as a tool to guide directors.

209. See *supra* note 15 and accompanying text.

210. *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986).

211. *Guidebook II*, *supra* note 59, at 321.

212. See *supra* note 145.

213. For example, in Southern Company's Notice of 1987 Annual Meeting of Stockholders and Proxy Statement, the Company proposed an amendment to its Articles of Incorporation as follows:

Article NINTH A director shall not be personally liable for monetary damages to the corporation or its shareholders for breach of fiduciary duty as a director except (a) for any breach of the director's duty of loyalty to the corporation or its shareholders, (b) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (c) under section 174 of the General Corporation Law of the State of Delaware or any successor provision, or (d) for any transaction from which the director derived an improper personal benefit.

Notice from Southern Co. to Stockholders (March 1987). See *supra* note 135 (requirements for amending certificate of incorporation).

214. For example, the Chicago Tribune reported that Stone Container Corporation sought to change its state of incorporation to Delaware from Illinois. Stone Container's Chairman, Roger Stone, said that the primary reason for reincorporating in Delaware was that its laws afforded greater protection to directors. Chicago Tribune, Apr. 21, 1987, § 3, at 3, col. 2.

Section 102(b)(7) will probably not reduce corporate takeover activity. The new statute presumably will make directors more aware of the nature of their fiduciary duties and to whom they owe such duties. Allowing incompetent management to complacently continue in its roles is an unlikely possibility. In this respect, the new statute will not make corporate America less efficient. Directors still will owe a duty of care to the corporation and its shareholders. The net result will be to allow corporations to obtain the best directorial talent because the directors will not be personally exposed to liability.

IV. CONCLUSION

The obligations a director owes to the corporation and its shareholders fall into two broad categories, a duty of loyalty and a duty of care. Historically, if a director breached either of these obligations he could be personally liable for such breaches. In order to allow Delaware corporations to continue to attract the best available talent, the Delaware legislature adopted a statute whereby a corporation can amend its articles to eliminate the personal liability of its directors for breaches of their duty of care. Since the legislature did not define the duties of care and loyalty, courts need to carefully craft case law so that directors know what their duties are in certain situations and so that the new statute becomes a powerful corporate tool. If, on the other hand, the courts use the latitude unwisely, continued confusion in the area of the business judgment rule will result.

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