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Discretion and Its Limits—An Analytical Framework for Understanding and Applying the Duty of Care to Corporate Directors (and Others)

Philip C. Sorensen
The Ohio State University, Moritz College of Law

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DISCRETION AND ITS LIMITS—AN ANALYTICAL FRAMEWORK FOR UNDERSTANDING AND APPLYING THE DUTY OF CARE TO CORPORATE DIRECTORS (AND OTHERS)

Philip C. Sorensen*

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I. INTRODUCTION

The legal artifices that shield corporate directors from liability for their negligent conduct are targets easily punctured by analysis.¹ The game grows tiresome,² however, as the artifices become more complex without becoming more explicable (or less explodable).³ Eventually, if one is inclined toward greater accountability for corporate management, the obligation to come forward and to suggest appropriate standards of conduct⁴ under the directors' duty of care becomes difficult to avoid.

1. See, e.g., Cary, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61 (Special Issue 1972); Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983); Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

2. "[The business judgment rule], which began as a minor exception, is now so dominant a winning argument that the only fun left is trying to prove that [it] . . . does not cover absolutely all forms of corporate theft." Bazelon, *Clients Against Lawyers*, 235 HARPER'S MAG. 104, 112 (Sept. 1967). Thanks are due David Cowan Bayne, S.J., for bringing this quotation to my attention through his treatise, *THE PHILOSOPHY OF CORPORATE CONTROL, A TREATISE ON THE LAW OF FIDUCIARY DUTY* (1986).

3. The American Law Institute's tentative drafts (AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* (Tent. Drafts No. 1 (1982), Nos. 2 & 3 (1984), No. 4 (1985) and Nos. 5 & 6 (1986)) [hereinafter ALI DRAFT No. —] and the American Bar Association's REVISED MODEL BUSINESS CORPORATION ACT (1984) [hereinafter REV. M.B.C.A.] manage (and intend) to do little more than codify the judicial confusion. See ALI DRAFT No. 4, *supra* § 4.01(a), at 14. Recent case law (e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)) has been more inventive than cogent. The duty of care can be said to be simplified only in those instances of recent statutes that have done away, or have permitted the doing away, with the duty in various contexts. See, e.g., IND. CODE § 23-1-35-1(e) (1986) and DEL. CODE ANN. tit. 8, § 102(b)(7) (1986).

4. The "standard [of conduct of a reasonable man under the circumstances] is, without more, incapable of application to the facts of a particular case. It requires further definition, so as to express the opinion of society as to what should be done or left undone by a reasonable man under the circumstances of the particular case." RESTATEMENT (SECOND) OF TORTS § 285 comment d (1965). See also W. KEETON, D. DOBBS, R. KEETON, & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS (Lawyer's Edition) § 37 (5th Ed., 1984) [hereinafter PROSSER].

That undertaking, however, leads in turn to an appreciation of the very real difficulties in particularizing standards of conduct without fundamentally altering the traditional authority of corporate directors.⁵

In typical contexts, standards of conduct under a duty of care, and defenses to that duty, assume a separation of identity between actor and victim.⁶ That is to say, choices regarding conduct and risks which bear upon liability are assumed to be made by the actor and victim independently and autonomously. A corporate director, however, traditionally has the authority to make those choices for the corporation (the victim in the directors' duty of care context),⁷ for example to decide for the corporation its acceptable levels of risk.⁸ Under these circumstances, the effort to establish standards of conduct under the directors' duty of care poses many of the same practical and metaphysical difficulties faced if we were to decide what is best for others solely in terms of themselves.

Standards of conduct under the directors' duty of care fix not only the level of protection for the corporation from risks of harm, but effectively determine the extent of the directors' independently recognized authority to define or to assume risks for the corporation.⁹ This latter consequence

5. State law has traditionally prescribed internal systems of corporate governance, vesting in the board of directors the power and authority to act for the corporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1983). *See also* REV. M.B.C.A. § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitations set forth in the articles of incorporation."). This legislative grant of authority to the board of directors would be undermined if courts did not adopt an attitude of deference to a board's decisions. *See* Burgman and Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the Trans Union Case*, 11 J. CORP. LAW 311, 321-22 (1986) ("[I]ike other of kinds of voluntary associations, corporations have their own internal systems of governance, and it is appropriate for courts to interfere as infrequently and as little as possible by substituting judicial judgments for decisions of the board.").

6. The law establishes a standard of conduct which an individual must follow in order to avoid subjecting *another* to an unreasonable risk of harm.

7. The directors' duty of care is a duty owing the corporation. Recovery for losses arising from a breach of the duty is available to the corporation in a suit initiated by it or by a shareholder suing derivatively on the corporation's behalf. *See generally* E. BRODSKY & M. ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS § 2.06 (Callaghan 1984). A decision by a board of directors, it should be noted, might constitute a violation of the directors' duty of care to their corporation and, at the same time, bring about corporate conduct which will violate the corporation's duty of care to third parties. *See infra* Part IV(C).

8. *See infra* Parts II and III(C)(2).

9. A pre-defined authority for corporate actors is necessary internally as a means to identify those who can decide issues within the corporation, and externally to establish the scope of authority of corporate agents in the context of dealings with third parties. Ellman, *Another Theory of Non-profit Corporations*, 80 MICH. L. REV. 999, 1001 (1982):

A corporation code deals principally with rules of internal governance. Such rules are

arises in other situations where the actor, the putative wrongdoer, has special claim to authority over factors crucial to legal liability. An application of the usual negligence standards to parents in regard to their minor children, for example, would effectively restrict the authority of parents to define acceptable levels of risk for their children¹⁰ (e.g., Should we permit Mary to climb the apple tree?). Thus, in establishing standards of conduct for parents under the duty of care owing their children, the scope of parental authority and family autonomy are no less being fixed than the quantum of care. Similarly situated are academics¹¹ and government officials¹² whose independently established authority may come into conflict with the standards of conduct under a duty of care.

The duty of care typically is understood to be in competition with an actor's freedom to act. The thesis of this article is that for certain actors the duty of care will also come into competition with that actor's independently valued authority to determine matters crucial to liability. Deferral to this, what I have chosen to call, discretionary authority¹³ necessarily yields to the actor what amounts to an immunity from the duty of care. The article reduces this thesis to a specific proposition and explores its implications for corporate directors, the most important of

made necessary by incorporation: If the law is to recognize the existence of a new kind of "person", it must offer some means to distinguish between legitimate actions taken on that "person's" behalf and unauthorized assertions of authority.

10. The problem arises due to the collision of the parental interests, not to mention duty, in rearing a child with the oftentimes inconsistent interests in protecting the child from injury. See *Nolechek v. Gesuale*, 46 N.Y.2d 332, 338, 413 N.Y.S.2d 340, 385 N.E.2d 1268, 1272 (1978). See also Note, *The Unsupervised Child: Parental Negligence or Necessity?*, 15 VAL. U.L. REV. 167, 181 (1980).

11. See, e.g., *Board of Curators v. Horowitz*, 435 U.S. 78 (1978).

12. In *Westfall v. Erwin*, 108 S. Ct. 580 (1988), the Court held that federal officials are immune from state tort law only when their conduct "is within the scope of their official duties and the conduct is discretionary in nature." *Id.* at 584.

The Federal Tort Claims Act, 28 U.S.C. § 1346(b) (1982), codifies the government's waiver of sovereign immunity,

for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the claimant. . . .

Id.

However, the Federal Tort Claims Act sets forth an important exception to this waiver of immunity: The waiver of immunity in § 1346(b) does not apply to "[a]ny claim based upon an act or omission of an employee of the Government . . . based upon the exercise or performance or the failure to exercise or perform a *discretionary function* . . . whether or not the discretion involved be abused." 28 U.S.C. § 2680(a) (emphasis added).

13. See *infra* note 38.

which is the need for a framework for consideration of the duty of care which incorporates the interests represented by the directors' discretionary authority. This framework is found in the forms and particulars of the limits to discretionary authority.

Current law affords varying degrees of special protection to corporate directors and to those other actors holding special claim to discretionary authority. But current law reflects, at best, only a vague intuition of the underlying conflicts, and, as a consequence, offers shifting and often incoherent formulations of these actors' duty of care. Certainly, the corporate director's duty of care cannot be hailed as a triumph of legal cogency, or indeed of legal efficacy. The duty provides inadequate protection for the corporation and, at the same time, acts as a source of insecurity for the corporate director.¹⁴ Recent economical and behavioral analyses,¹⁵ while providing insights into the directors' duty of care, have yet to offer any satisfactory resolution to these dual concerns. Insight into the competing, discretionary authority of directors and into the limits to that authority, however, offers the opportunity to establish standards of conduct capable of particularization and which need not ignore either the reality or the responsibility of management.

This article begins with an examination of the peculiar state of corporate directors and their duty of care. It next examines discretionary authority and its limits, including the question of whether discretionary authority might be merely an illusion, or perhaps a by-product of other interests sought to be served. I conclude that it is neither. This article next analyzes the claim of corporate directors to discretionary authority. It proposes and tests against typical cases standards of conduct that measure two crucial factors, limits of discretion and economic utility. Finally, it explores the adaptability of the proposed tests to the current legal framework.

The insights offered by discretionary authority and its limits are not confined to the corporate director's duty of care. Indeed, the analytical framework produced offers a guide for formulating standards of conduct in any situation where the actor, whether public or private, has a legiti-

14. While much of the increase in exposure to liability for corporate directors arises from new sources for liability (e.g., RICO), there is no doubt that recent caselaw (see *infra* note 16 for examples) has contributed a duty of care layer to their sense of insecurity.

15. See, e.g., Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1980); Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985).

mate and independent claim to authority over matters dispositive of liability. The extension of this framework to actors other than corporate directors will be addressed in a subsequent article.

II. THE PUZZLING STATE OF THE CORPORATE DIRECTORS' DUTY OF CARE

That something has been amiss with the corporate director's duty of care is hard to deny. How else explain its apparent corruption and, but for a few recent exceptions,¹⁶ stagnation?¹⁷ In most jurisdictions, a corporate director is required by statute or common law to discharge his or her duties "with the care an ordinarily prudent person in a like position would exercise under similar circumstances."¹⁸ Such a duty has, in all other contexts, been regularly and successfully asserted by injured parties seeking redress.¹⁹ Why such contrasting results when applied to corpo-

16. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

17. The courts have been extremely reluctant to impose liability upon corporate directors for breach of the duty of care in the absence of fraud or self-dealing. One oft-quoted commentator has observed that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). This observation remains valid today. See Burgman and Cox, *supra* note 5, at 312; Manning, *The Business Judgment Rule in Overview*, 45 OHIO ST. L.J. 615, 619 (1984); Cohn, *supra* note 1, at 592-93. In Comment h. to § 4.01(a) of the ALI DRAFT No. 4, it is noted, "Since the turn of the century there have been only thirty or so cases reflected in appellate opinions—almost invariably involving egregious facts—where directors or officers have been found to have violated duty of care obligations." ALI DRAFT No. 4, *supra* note 3, § 4.01(a), at 28-29.

18. See, e.g., the duty of care provisions set forth in the Revised Model Business Corporations Act:

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.

Rev. M.B.C.A., *supra* note 3, § 8.30(a) (emphasis added).

ALI Reporter's Note 15 to the Comment to sec. 4.01(a) states, "[A] reasonable care culpability standard has been articulated in a substantial majority of the jurisdictions that have addressed the issue." ALI DRAFT No. 4, *supra* note 3, at 39.

19. Consider, for example, the wealth of court cases involving recovery for breach of the ordinary standard of care in such contexts as automobile accidents, medical malpractice suits, etc. See, e.g., *Marks v. Mobil Oil Corp.*, 562 F. Supp. 759 (E.D. Pa. 1983), *aff'd*, 727 F.2d 1100 (3rd Cir. 1984) (award of \$5,147,000 was upheld in personal injury action arising from an automobile accident); *Sternemann v. Langs*, 93 A.D.2d 819, 460 N.Y.S.2d 614 (1983) (damage award of \$1,000,000

rate directors? Is it that directors are always so careful and correct? Do juries suddenly tilt toward defendants when they are corporate managers? Do judges seek to protect corporate directors more than, say, attorneys or physicians? Does the exercise of business judgment require little care, or the redress of injuries arising from its negligent exercise require little legal intervention? Are the common standards of business conduct more lax than those of other activities?

There is no lack for explanations, but most are unconvincing. Courts are poor supervisors of business managers, goes one²⁰—a truism, of course, but wide of the point since the imposition of a duty of care is hardly the equivalent of supervision. Business is too arcane for courts to establish proper standards of conduct for the care to be taken by its managers, goes another.²¹ This (unproven) assertion as an explanation for the duty's dormancy, however, is inconsistent with the willingness of courts to establish and enforce duties of care for those who engage in a wide variety of other, equally arcane, pursuits (and normatively irrelevant, as well, unless one holds that legal duties ought to be confined to prosaic activities). The possibility that penalties may prove too severe²² seems equally implausible as an explanation since this possibility has not inhibited courts from enforcing recognized duties in other areas of the law where awards have soared.²³

was not excessive in medical malpractice action); *Warmley v. City of New York*, 89 A.D.2d 982, 454 N.Y.S.2d 144 (1982) (in action to recover for personal injuries suffered in auto accident, jury award of \$2,000,000 affirmed); *Nowasco Services Div. v. Lassman*, 686 S.W.2d 197 (Tex. Civ. App. 1984) (appellate court upheld damage award of \$745,759.46 for personal injuries sustained in an oil rig accident).

20. See, e.g., Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1288 (1982) ("There is no reason to believe that courts can systematically improve on the business decisions made by corporate managers. Courts (and shareholders) do not possess the experience, expertise, or information necessary to make complicated business decisions.").

21. It is this presumed lack of judicial ability to comprehend the complexities of the commercial world that underlies the business judgment rule. Cohn, *supra* note 1, at 607. Some commentators also feel definition of the directors' duty in corporate governance is beyond the reach of the law. See Andrews, *Corporate Governance Eludes the Legal Mind*, 37 U. MIAMI L. REV. 213 (1983). Professor Andrews argues that corporate leadership "requires values and skills in intricate combinations that cannot be prescribed by black letter law." *Id.* at 215. Cf. Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (1984). Professor Coffee discounts this position by arguing that "[u]nder [Professor Andrews'] view, the law of torts would have long since withered away in the face of claims by various professions that their standards could not be understood by the 'legal mind.'" *Id.* at 790 n.2.

22. Cohn, *supra* note 1, at 595.

23. For instance, a physician's duty of care is as vigorously enforced now as ever, despite soaring judgments.

One explanation for the duty's dormancy, often voiced by the business community, is that the duty fails to reflect the realities of corporate management.²⁴ Presumably, this is not to assert that corporate directors cannot act, in the real world, with the care of "ordinarily prudent persons in like positions and under similar circumstances." Perhaps what is meant is that the duty is incapable of translation into standards of conduct for particular cases that are meaningful in terms of the care to be taken, yet realistic from a business decision-maker's perspective.²⁵ If so, then we have not only a plausible explanation for the duty's dormancy but, as well, a justification therefor. Without realistic standards to distinguish between careful and careless conduct, we should expect courts to be reluctant to send claims to a jury or otherwise make possible a plaintiff's verdict.²⁶ Certainly no one proposes to impose strict liability upon corporate directors or to inhibit the proper exercise of their responsibilities, as would be the case if the duty of care were to be enforced without appropriate and adequately articulated standards of conduct.

What substance is there to the assertion that the directors' duty of care cannot be translated into realistic standards of conduct, i.e., standards that would provide a basis for distinguishing conduct that produces unreasonable risks from conduct that produces only reasonable risks? The duty of care does not, of course, seek to eliminate risk-taking, only unrea-

24. See Cohn, *supra* note 1, at 600. Professor Cohn argues that courts recognize an implicit difference between legal standards and corporate realities. Accordingly, there is a judicial reluctance to apply unrealistic legal standards to the corporate world. See also criticisms of the directors' duty, advanced by the business community in STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" 33-35 (1983) [hereinafter BUSINESS ROUNDTABLE].

25. Cohn, *supra* note 1, at 638. Professor Cohn concludes that the dominance of the business judgment rule as a means to insulate directors from liability is misplaced. He attributes the strength of the doctrine to fundamental judicial concern with ambiguous standards and the significant disparity between theory and reality in imposing legal obligations on directors.

26. *Id.* See also Fischel and Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986). Professors Fischel and Bradley argue that liability rules have a limited role to play in the area of corporate governance. The limited usefulness is a consequence of various factors, including the difficulty in distinguishing a director's poor performance from other causes of a bad outcome, and also the difficulty in determining whether a particular act constitutes a breach of the duty. *Id.* at 264.

See also *Auerbach v. Bennett*, 47 N.Y.2d 619, 630, 419 N.Y.S.2d 920, 926, 393 N.E.2d 994, 1000, (1979) ("[t]he authority and responsibility vested in corporate directors . . . proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise."). See generally *infra* notes 39-42 and accompanying text.

sonable risk-taking.²⁷ Is there truly such a distinction when it comes to business decisions by corporate directors? Is it a distinction which can be made at the time directors act? Is it a distinction which can be particularized (through standards of conduct) by the courts for discrete cases? Upon these three questions, it would appear, turn the validity and viability of the directors' duty of care. While the existence of a director's duty of care implies an affirmative answer to each of them, the general quiescence of the duty suggests otherwise. The contradiction arises, I would suggest, because we answer the questions affirmatively only in principle. We have failed to uphold those answers with adequate particulars. Examine the particulars.

Standard tort doctrine, of which the directors' duty of care is a part,²⁸ holds that a victim's voluntary and knowing submission to a risk may either excuse the actor's negligent conduct or convert that conduct into non-negligent behavior.²⁹ This possible defeat of a claim for negligence, dependent as it is upon the actions of the victim, becomes all but certain in the context of the duty of care that directors owe a corporation. There the duty is victim-specific, that is, it is a duty owed only to one party.³⁰ Moreover, there the actors, the directors, have the authority to select on behalf of the one potential victim, the corporation, the risk-taking activi-

27. Significant corporate risk-taking is an integral part of the managerial/directorial function. Burgman and Cox, *supra* note 5, at 343. See also Manning, *supra* note 17, at 622. ("From a social standpoint, innovation and risk-taking are exactly what directors . . . should be encouraged to pursue.")

28. See Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 341 (1965)("[The director's duty of care] is, after all, the application of the law of torts to the corporate director . . .").

29. A victim's tort claims may be defeated by actions on his part which give rise to the defense of assumption of risk (a voluntary consent to encounter such risks) or contribute to the actor's conduct being deemed reasonable under the circumstances (a voluntary participation in an activity while knowing its risks which risks are essential to the utility of the activity). See generally PROSSER, *supra* note 4 at § 68, pp. 480-98. Participants and spectators at sporting events provide many such examples. *Id.* at 485. See *Richmond v. Employers' Fire Ins. Co.*, 298 So. 2d 118 (La. Ct. App. 1974) ("one who participates in a game or sport assumes the risk of injuries which are inherent in or incidental to that game or sport"), *writ denied*, 302 So. 2d 18 (La. 1974); *Robillard v. P&R Race-tracks, Inc.*, 405 So. 2d 1203 (La. Ct. App. 1981) (stock car drag racer was precluded from recovery following collision with disabled vehicle because racer knowingly assumed risk of injury); *Tavernier v. Maes*, 242 Cal. App. 2d 532, 51 Cal. Rptr. 575 (1966) (second baseman in softball game could not recover for injury sustained when another player collided with the plaintiff while sliding into base); *Kabella v. Bouschelle*, 100 N.M. 461, 672 P.2d 290 (N.M. Ct. App. 1983) (no recovery for injuries suffered in informal tackle football game in the absence of recklessness or intentional misconduct).

30. Here, unlike negligence law generally, no argument can be made that the duty is one owed to the world at large. Cf. Judge Andrews dissent in *Palsgraf v. Long Island Railroad Co.*, 248 N.Y. 339, 347, 162 N.E. 99, 101 (1928).

ties to which it will voluntarily and knowingly submit. In other words, in the boardroom setting of the duty of care, the actors have the power to choose the game the victim will play. If then the actors' choice results in harm to the victim, they may be excused from liability because presumably the victim, also through the actors' conduct, voluntarily and knowingly chose to participate in that particular game with all of its attendant risks. This remarkable circumstance makes the directors' duty of care a duty difficult either to breach or to prove.

Contrast the different results which can arise from a single board decision. If the board of directors of XYZ Corp., for example, has decided against the installation of radar on its ocean-going tugs and XYZ Corp. thereby becomes liable for collision damages to a third party, it does not follow that XYZ Corp. can recover for its own losses from its board of directors. While the conduct of the board (which, to third parties, is the conduct of XYZ) may have created an unreasonable risk of harm to those third parties, the risk of harm to XYZ, consisting of a threat of loss to its own tugs as well as the threat of third party liability, is not necessarily unreasonable. That is dependent, in part, upon the utility of the risk to, specifically, XYZ. Thus, irrespective of the nature or quality of the risk created for third parties by particular board action, the quality of the risk created for the corporation will be unique.

Moreover, the quality of that risk to the corporation must be determined within the context of conditions which the board (generally) has the power to fix. Inhering in any board decision³¹ are judgments as to what risks are to be assumed by or to be deemed reasonable to the corporation. Directors, for purposes of the duty of care, act simultaneously for themselves and for the corporation. Their decisions (whether to install radar on the company's ocean-going tugs, contribute corporate funds to charity, or merge with another corporation) constitute the conduct which will be adjudged reasonable or unreasonable vis-a-vis the corporation. Yet at the same time, their decisions also cause or constitute corporate action: both the corporate action which may be deemed reasonable or unreasonable vis-a-vis third parties, and, here the crux, the corporate action which determines what are reasonable or unreasonable risks for the corporation to encounter or assume. The dilemma thereby posed to

31. The oversight function of directors may or may not involve formal decisions. Even absent a formal or conscious decision, the standards of conduct proposed here apply equally to this function, although the need to prove causation is likely to prevent recoveries in most situations. *Barnes v. Andrews*, 298 F. Supp. 614 (S.D.N.Y. 1924).

those who would apply a duty of care to directors' decision-making is that the directors are sought to be held liable for acts alleged to be unreasonable vis-a-vis the corporation when they, in fact, decide what is or is not unreasonable to the corporation.

Judicial and legislative contrivances such as the business judgment rule,³² gross negligence as the standard of care,³³ limits on liability,³⁴ or reliance on procedural flaws to establish negligence³⁵ (long ago rejected in general negligence law)³⁶ have proven to be artificial and inadequate responses to this dilemma. They do offer a resolution of the directors' duty of care that does not fundamentally alter directors' traditional authority, but it is a resolution that eviscerates nearly all of the duty's substance.

32. The business judgment rule is well-established in the case law of most jurisdictions. While varying from one jurisdiction to another, in general the rule can be summarized as follows:

[W]hen a board of directors has acted with reasonable care and in good faith, its decisions will be regarded as business judgments and will not be liable for damages even when a decision proves to be detrimental to the corporation.

Manning, *supra* note 17, at 617. (The requisite "reasonable care" is generally understood to refer to the care taken in the process of decision-making.)

"[T]he large majority of business judgment cases have afforded broader protection to directors and officers than a 'reasonableness' test would provide." ALI DRAFT No. 4, *supra* note 3, § 4.01, reporter's note 4, at 75 (1985).

33. ALI DRAFT No. 4, § 4.01, reporter's note 15, at 39. Only three states (Alabama, Kentucky, and Wisconsin) "have case law unambiguously adopting a 'gross negligence' standard." Other states have certainly flirted with the idea. *See, e.g., Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 411, 8 N.E.2d 895, 905 (1937) ("If directors, acting in good faith, nevertheless act imprudently, they cannot ordinarily be held to personal responsibility for loss unless there is 'clear and gross negligence' in their conduct."); *Holland v. American Founders Life Insurance Co. of Denver*, 151 Colo. 69, 376 P.2d 162 (1962); *Aronson v. Lewis*, 473 A.2d 805, 812 n.6 (Del. 1984) ("director liability is predicated on a standard which is less exacting than simple negligence"); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (gross negligence is the applicable standard for determining whether directors are protected by the business judgment rule).

34. *See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7)* (1986). For other statutory provisions limiting the scope of director liability, *see generally Hazen, Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C. L. REV. 171 (1987).

35. "With one very limited exception, . . . the due care standard in a corporate context under current law is applied not to the decision of the director, but rather to the process by which that decision is reached." ABA SECTION OF LITIGATION'S COMMENTS TO THE AMERICAN LAW INSTITUTE PROJECT ON "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, TENTATIVE DRAFT NO. 1" (1982) (hereinafter ABA SECTION OF LITIGATION). *See generally Burgman & Cox, supra* note 5, at 350-51.

36. *See Seavey, Negligence — Subjective or Objective?*, 41 HARV. L. REV. 1 (1927). I would add that care must ultimately be judged on more than process. Otherwise, those charged with the duty of care need only go through the form to protect themselves against the most stupid of judgments.

III. DISCRETIONARY AUTHORITY AS A FRAMEWORK FOR ANALYZING THE DUTY OF CARE OF DIRECTORS AND OTHERS

A. *A Statement of the Proposition*

If tort liability may be avoided by actions of the victim (e.g., assumption of risk) or by circumstantial modification of the standards of conduct (e.g., the emergency doctrine, the qualifier “under like circumstances”)³⁷, then actors enjoying an authority to act on behalf of victims or to define the circumstances of their actions will possess, as a consequence of that authority, the power to avoid liability. In short, a legal cession or concession of authority to an actor to make choices dispositive of liability must logically result in something very much akin to immunity for that actor. I have called this authority to make such choices “discretionary authority.”³⁸ The proposition that discretionary authority grants a type of immunity, while self-evident, nevertheless carries considerable heuristic power. First, it separates the issue of authority from those of immunity or standards of conduct (and thereby identifying, I believe, the source for much of the long-standing confusion about the duty of care of corporate directors, parents, and others). Secondly, it provides a more apt framework—discretionary authority and its limits—for the analysis of liability in those circumstances where its premises apply.

37. A plaintiff’s voluntary assumption of the risk, when adequately proven, may serve as a defense to an action brought against a defendant whose conduct would otherwise subject him to liability to the plaintiff. See generally RESTATEMENT (SECOND) OF TORTS § 496A-496G (1965).

Similarly, a defendant may also escape liability for conduct which may be deemed negligent under ordinary circumstances, but which may *not* be considered negligent if the defendant is faced with a “sudden emergency” requiring rapid decisionmaking. See *id.* at § 296. See also PROSSER, *supra* note 4, at 196.

38. The common dictionary definition of discretion is “the power of decision; individual judgment; power or freedom of choice within legal bounds.” WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE (1961).

Legal commentators have attempted to refine the definition of discretion as applied to the judicial arena: “If the word discretion conveys to legal minds any solid core of meaning, one central idea above all others, it is the idea of choice.” Rosenberg, *Judicial Discretion of the Trial Court, Viewed From Above*, 22 SYRACUSE L. REV. 635, 636 (1971) (footnote omitted).

I have intentionally avoided using the word “discretion” independently, but have linked it with “authority” in order to indicate a legitimate power of choice. Discretionary power, without legitimacy, abounds (e.g., Shall I take your life?). An individual’s claim to discretionary authority can rest upon several grounds (see Part III(C)), but ultimately the legitimacy of such authority must be sealed through judicial recognition.

B. Distinguishing Discretionary Authority from Similar Phenomena

Judicial deferral to an actor's discretionary authority, with its consequential shielding of that actor from liability for the exercise of that authority, closely resembles two other phenomena: immunity from liability, and the judicial broadening of the bounds of reasonable conduct in particular relationships or circumstances. Both of these other phenomena permit a range of discretion in an actor's choice of conduct, creating an appearance not unlike that of an actor possessing the authority to determine matters dispositive of liability (e.g., a grant of immunity necessarily concedes to the actor essentially an unreviewable discretion over conduct relating to the victim or the circumstances)³⁹. In both of these other phenomena, however, discretionary authority—if it can even be called authority—is a by-product rather than a motivating force. The distinction is significant.⁴⁰

Whether to afford some persons immunity is a different question, raising different concerns, than whether to recognize and defer to their authority over others. Immunity can exist apart from a possession of authority to direct or act on behalf of others (e.g., diplomatic immunity), while the presence of authority over others does not automatically imply immunity (e.g., a ship's captain). Immunity may be independently desirable, that is, desirable without regard to the discretionary authority it might confer, and so too, discretionary authority may be independently desirable, with its consequential immunity viewed as a cost. Indeed, the immunity of actors that necessarily arises from their discretionary authority is generally nothing more than the price of that authority. In situations where immunity and authority are present and already in place, the controlling motivation may not be readily apparent; neverthe-

39. For instance, the absolute immunity from tort liability granted to judges and legislators is not lost even if action is taken maliciously or with deliberate intent to inflict injury. K. DAVIS, 5 ADMINISTRATIVE LAW TREATISE § 27:19 at 100 (2d ed. 1984). Thus, "a judicial officer, in exercising the authority vested in him, shall be free to act upon his own convictions, without apprehension of personal consequences to himself." *Id.* (citing *Bradley v. Fisher*, 80 U.S. (13 Wall) 335, 347 (1871)).

40. It is also important to distinguish those situations where discretionary authority is the consequence of a lack of court jurisdiction. Manifestly, a court without jurisdiction over either the subject matter or the person of the actor leaves that actor with what amounts to discretionary authority. But, as with immunity or broad boundaries of reasonable conduct, the absence of jurisdiction raises entirely different issues and seeks altogether different goals than a judicial concession of discretionary authority to an actor. Moreover, our inquiry here concerns actions where courts do indeed ordinarily exercise jurisdiction over the subject matter and the actors.

less, its identity can be important, especially when considering proposals to modify or abolish the status quo.

Similarly, whether to establish broad legal standards of reasonableness in particular circumstances poses a different question, raising different concerns, than the question of whether to grant, within the same broad boundaries, either immunity or discretionary authority. As discussed later, courts can and do place outer limits on an actor's discretionary authority⁴¹ (or immunity), thereby creating an appearance not notably different from that where a court defines reasonableness so broadly in the particular relationship and circumstances as to extend the scope of an actor's acceptable conduct to the same outer limits. Nevertheless, whether conduct falls within or without the boundaries of reasonableness is an issue of fact; whether conduct falls within the bounds of immunity or an actor's discretionary authority is an issue of law.⁴² More importantly, identifying the principal motivation is essential to discerning the considerations material to establishing, modifying, or repealing those outer boundaries.

C. *Discretionary Authority in Private Hands*

1. *In General*

The discretionary authority of many public officials and agencies—courts,⁴³ legislatures,⁴⁴ police and prosecutors,⁴⁵ administrative agen-

41. See *infra* notes 70-74 and accompanying text.

42. See PROSSER, *supra* note 4, at 1066.

43. See, e.g., Rosenberg, *supra* note 38, at 646-650 (the "keynote approach" found in state and federal appellate court decisions conveys an attitude of extreme deference to the trial judge in reviewing discretionary matter).

44. See, e.g., *Solem v. Helm*, 463 U.S. 277, 290 (1983) ("Reviewing courts, of course, should grant substantial deference to the broad authority that legislatures necessarily possess . . . in sentencing convicted criminals."); *Rescue Army v. Municipal Court of City of Los Angeles*, 331 U.S. 549, 571 (1947) (noting "the necessity, if government is to function constitutionally, for each [branch of government] to keep within its power, including the courts"); *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 345-54 (1936) (Brandeis, J., concurring) (discussing "'great gravity and delicacy' of [the Court's] function in passing upon the validity of an act of Congress"); *United States v. Davis*, No. 86-1103, slip op. (8th Cir. Dec. 18, 1986) (illustrating reluctance of courts in reviewing legislative mandates of imprisonment terms).

45. See, e.g., *Imbler v. Pachtman*, 424 U.S. 409 (1976) (prosecutor was afforded absolute immunity from damages under § 1983 in performing functions of initiating prosecution and advocating case); *Abernathy v. U.S.*, 773 F.2d 184 (8th Cir. 1985) (government's decision not to prosecute individual who suffered from brain disorders for assault was a discretionary decision. Thus, victim's father was precluded from recovery on a theory that the government failed to prosecute under the discretionary function exception to the Federal Tort Claims Act); *Wright v. U.S.*, 719 F.2d 1032 (9th

cies⁴⁶—has long been recognized. Is it an authority that can, justifiably, be extended in some circumstances to private actors? On what bases might a court refrain from imposing on private parties the standards of conduct normally applied and, instead, accord them the authority to establish the legal character of their conduct?

Two, perhaps more, bases appear sufficiently vital to justify judicial deference. The first basis might be described as judicial modesty; courts could defer to the actor's choice of conduct because there is no source equal to or better than the actor to determine the reasonableness or propriety of that conduct in the particular context.⁴⁷ Logic, experience, values, or preferences, for example, may provide no guidance, at least within certain limits of discretion (limits, as will be seen, are another issue). Similarly, no sound basis may exist for elevating the standards estab-

Cir. 1983) (decision of whether to prosecute a given individual is a discretionary function for which the United States is immune from liability under the Federal Tort Claims Act).

46. Under the Administrative Procedure Act, 5 U.S.C. § 701(a) (1982), judicial review of agency acts is unavailable to the extent that a statute precludes judicial review, or the agency action is committed to agency discretion by law.

47. Courts are particularly unwilling to review discretionary acts in the administrative law context based on the allocation of power between agencies and reviewing courts. This allocation is dependent on the assessment of the comparative qualifications of the decisionmaker. Davis, *supra* note 39, at § 27.11. For example, the discretionary function exception to government liability in a tort suit serves to limit the court's power to substitute its own decisions for those better made by the executive. Rogers, *A Fresh Look at Agency "Discretion"*, 57 TUL. L. REV. 776, 806 (1983).

A major reason for the great deal of deference afforded to the decisions of a trial judge upon appellate review lies in the perception that the judge is in a better position to decide the matter fairly because proximity to the action affords an opportunity to hear and observe more than an appellate record can reflect. Rosenberg, *supra* note 38, at 665.

The impropriety of judicial decisionmaking in the area of academic institutions has also been recognized. In *Regents of the University of Michigan v. Ewing*, 474 U.S. 214 (1985), the United States Supreme Court refused to substitute its own decision for that of the faculty in dismissing a student, based on the presumed expertise of the faculty in rendering professional judgment. See also *Board of Curators of Univ. of Missouri v. Horowitz*, 435 U.S. 78, 89-90 (1978) (academic decisions require "an expert evaluation of cumulative information and [are] not readily adapted to the procedural tools of judicial or administrative decisionmaking.").

Judicial deference to corporate directors has been justified on this basis. Note, *Alford v. Shaw: North Carolina Adopts a Prophylactic Rule to Prevent Termination of Shareholders' Derivative Suits Through Special Litigation Committees*, 64 N.C.L. REV. 1228, 1243 (1986). See also Brown, *Shareholder Derived Litigation and the Special Litigation Committee*, 43 U. PITT. L. REV. 601, 608 (1982) (recognizing the institutional inadequacy of the courts to exercise judicial power effectively in matters of business judgment); *Auerbach v. Bennett*, 47 N.Y.2d 619, 631, 419 N.Y.S.2d 926-27, 393 N.E.2d 994, 1000, (1979) ("[B]y definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility.").

lished by others over those of the actor.⁴⁸ Without authority superior to the actor to establish appropriate standards of conduct, there is limited justification, if any, for imposing judicial standards of conduct on the actor.⁴⁹ Judicial modesty may also be the appropriate response to open-ended questions that do not lend themselves readily to adjudication⁵⁰ (e.g., intrafamily disputes of various sorts resource allocation). Again, absent the ability to formulate standards of conduct superior to those established by the actor, deferral to the actor's choice of conduct could be an appropriate judicial response.

48. A compelling example of such "judicial modesty" is illustrated by the broad range of discretion granted to trial judges upon appellate review. See Rosenberg, *supra* note 38, at 662: "When the ruling under attack is one that does not seem to admit of control by a rule that can be formulated or criteria that can be indicated, prudence and necessity agree it should be left in the control of the judge at the trial level." Thus, meaningful appellate review of ordinary trial level decisions is often precluded if the matter at issue is not readily amenable to legal standards.

In the corporate context, judicial modesty is often offered as the basis for permitting wide discretion. "Courts lack the training and experience necessary for directly reviewing the manifold decisions made by directors. Given the highly discretionary nature of most business decisions, no objective criteria exist for a court to measure the correctness of a given business decision." Brown, *supra* note 47, at 608.

In the area of administrative law, judicial review of agency acts is precluded if "the statute is drawn so that a court would have no meaningful standard against which to judge the agency's exercise of discretion." Heckler v. Chaney, 470 U.S. 821, 830 (1985); see also Doe v. Casey, 796 F.2d 1508, 1517 (D.C. Cir. 1986) (agency's discretion is completely nonreviewable if the statutory scheme, taken with other relevant materials, provides absolutely no guidance as to how that discretion is to be exercised).

Another example of judicial modesty, although with a broader application, is the judicial concession of medical malpractice standards to the customary or accepted practices of the medical profession. See PROSSER, *supra* note 4, at 198.

Finally, the Court's concern with lack of standards is also apparent in the context of judicial review of academic decisions. Ewing, *supra* note 47, at 226.

49. Deference is premised on the actor's conduct being taken in good faith and without a disabling conflict of interest. Absent such, there is justification (e.g. objectivity) for elevating independent standards over those of the actor.

50. Fuller and Henderson in particular have developed this concept. See Fuller, *Adjudication and the Rule of Law*, 54 PROC. AM. SOC'Y OF INT'L L. 1, 3 (1960) (open-ended problems do not lend themselves to adjudication because there are "no clear issue[s] to which either side could direct its proofs and contentions."); Henderson, *Expanding the Negligence Concept: Retreat from the Rule of Law*, 51 IND. L.J. 467 (1976) (notes the difficulty in adjudicating cases "in which a complicating factor makes it unmanageably awkward to purport to ask how a reasonable person in the defendant's position would or would not have acted." Henderson further notes that "there is probably no such thing as a problem—even a classically legal problem—without a certain amount of open-endedness." What concerns him "are problems which tend toward the extreme on the scale of [being] open-ended . . ." *Id.* at 476. Henderson further notes that even highly open-ended problems can be adjudicated. "The important thing to recognize," he continues, "is that . . . the parties affected by the decisions are, in proportion to the extent to which the problems are open-ended, denied the opportunity to participate meaningfully in the decision process." *Id.*)

A second, important basis for deferral would arise if greater weight were given to the autonomy of the parties, actor and victim (e.g., parent and child), in their particular context or relationship than to the interests protected by the legal duty which interferes with that autonomy.⁵¹ Even if the actor is not necessarily a better source for defining that legal duty, deference to his discretionary authority may be justified in order to protect this autonomy.⁵²

Note that the presence of alternative remedies for misconduct (for example, internal corporate remedies), although alone not a sufficient basis

51. An illustration of this basis of deferral is provided by the parental tort immunity doctrine. The parent-child tort immunity rule at common law evolved to preserve the parental duty to rear a child. See Note, *supra* note 10, at 168-177. A number of jurisdictions have adhered to the broad view supporting parental immunity for negligent injury to a minor child. This immunity is premised on the courts' reluctance to interfere with duties inherent in the family relationship. See, e.g., *Coleman v. Coleman*, 157 Ga. App. 533, 278 S.E.2d 114 (1981); *Egbert v. Penk*, 57 Or. App. 830, 646 P.2d 639 (1982).

Even in some jurisdictions which have abrogated the general doctrine of parental tort immunity, parental liability has not been extended to a parent's exercise of authority over the child or an exercise of parental discretion regarding the child's care. See *Paige v. Bing Const. Co.*, 61 Mich. App. 480, 482, 233 N.W.2d 46, 49 (1975) ("[a]llowing a cause of action for negligent supervision would enable others, ignorant of a case's peculiar familial distinctions and bereft of any standards to second guess a parent's management of family affairs. . . .") *Id.* at 482, 233 N.W.2d at 49). See also *Streenz v. Streenz*, 106 Ariz. 86, 471 P.2d 282 (Ariz. 1970); *Wagner v. Smith*, 340 N.W.2d 255 (Iowa 1983); *McCallister v. Sun Valley Pools, Inc.*, 100 Mich. App. 131, 298 N.W.2d 687 (1980).

The immunity afforded to a public official in carrying out discretionary official duties also illustrates the courts' accordance of greater weight to the interests served by a policy of immunity. The defense of official immunity involves a balance between the benefit in compensating injured individuals by subjecting the officer to personal liability, and the undesirable effects flowing from holding the officer personally accountable. *Sowle, Qualified Immunity in Section 1983 Cases: The Unresolved Issues of the Conditions For Its Use and the Burden of Persuasion*, 55 TUL. L. REV. 326, 392 (1981). The policy basis for extending immunity to officials exercising discretionary functions lies in the perception that civil liability will hinder effective government operations. *Id.* at 386. The grant of immunity serves to preserve the official's willingness to vigorously exercise his duties in the interest of the public welfare. *Id.*

The Supreme Court's reluctance to intervene in academic decisionmaking rests to a large degree on this concern for preserving autonomy.

Added to our concern for lack of standards is a reluctance to trench on the prerogatives of state and local educational institutions and our responsibility to safeguard their academic freedom. . . . Academic freedom thrives not only on the independent and uninhibited exchange of ideas among teachers and students, but also . . . on *autonomous decisionmaking by the academy itself*.

Ewing, supra note 47, at 226 n.12 (citations omitted) (emphasis added). See also *Horowitz*, 435 U.S. at 90, ("We decline to further enlarge the judicial presence in the academic community and thereby risk deterioration of many beneficial aspects of the faculty-student relationship.")

52. Of course, both justifications may be present to restrain judicial review of the substance of the decision. See, e.g., *supra* notes 43-48 for a discussion of the presence of both autonomy and judicial modesty in the context of administrative agency review.

for deferring to an actor's choice of conduct, may nevertheless strengthen the case for judicial deference.

If, then, one or both of these justifications for discretionary authority is in fact present in a particular situation, the judicial imposition of legal standards that undermine or displace that authority may be unwise. Certainly without adequate recognition for such justifiable claims to discretionary authority, one could expect dissatisfaction and confusion to arise. Indeed, the persistent dissatisfaction and confusion about the applicability of the general tort duty of care to corporate directors and parents strongly suggest the presence of underlying claims to discretionary authority.

2. *The Claim to Discretionary Authority for Corporate Directors*

Corporate directors have a persuasive claim to discretionary authority as a corollary to their claim of authority to determine what risks are reasonable or acceptable to the corporation. The source for both claims is the considerable value society places upon the autonomy of the corporation to determine, *inter alia*, its acceptable levels of risk.⁵³ Because the corporation can do so only through its agents,⁵⁴ this aspect of corporate autonomy cannot be protected without protecting the authority of its agents to make such determinations on the corporation's behalf.⁵⁵

53. Perhaps autonomy is here highly valued because of the open-ended nature of corporate decisions. Whether or not autonomy is itself the end or simply an explanation for avoiding adjudication of issues not suitable to adjudication, the case is strong for conceding to the directors the authority to assess and weigh the risks to be taken.

Note too that a fundamental norm in corporate law is that the *board* governs the corporation and is responsible for formulating corporate strategy. Burgman and Cox, *supra* note 5, at 353. Society has a strong interest in encouraging qualified people to engage in reasonable risk-taking. Public policy favors creativity and innovation in corporate management. See Brown, *supra* note 47, at 608; Cohn, *supra* note 1, at 637-38; Manning, *supra* note 17, at 622. Indeed, proposed changes in corporate law doctrine which limits managers'/directors' autonomy have been met by criticism and disapproval from both legal commentators and the business community. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 2 (1984); BUSINESS ROUNDTABLE, *supra* note 24, at 50 ("directors must not be deterred from taking risks or focusing all their attention on matters that seem crucial at the time"); Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) ("it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions").

Burgman and Cox would ground judicial deference in the internal governance prescribed by statute. Burgman and Cox, *supra* note 5, at 322.

54. See *supra* note 5.

55. A Note in the Harvard Law Review (Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983)), despite its title, punts on the issue of judicial deference in "nonconflictual situations" (i.e., situations involving no conflict of loyalty). *Id.* at 1913.

The validity of these two propositions—the desirability of corporate risk-setting autonomy and the necessity for corporate agents to exercise that autonomy for the corporation—while appearing to be self-evident, nevertheless deserves more careful examination. Whether it is desirable for corporations to establish their own levels of acceptable risk ultimately asks whether we want corporations to be able to determine, in economic argot, the utility to themselves of certain and uncertain values. Certainly we find it desirable to let individuals determine that matter for themselves⁵⁶—they may decide, for a variety of reasons we deem legitimate (and therefore without incurring legal penalty), to invest in a scheme to carry coal to Newcastle or an expedition to search for gold in New Jersey or they may choose to skydive or climb Mt. Everest. This worth we find in individual autonomy is not necessarily diminished by the individual's employment of the corporate form. The interposition of the artificial entity of the corporation does not, for example, automatically lessen (or make vicarious) the pleasure to the individual of investing in, say, the theater. Unless the corporate concession by the state somehow restricts the multitude of legitimate, investor goals, the use of the corporate form should not in itself eliminate the worth we might find in risk autonomy. Existence as a corporate entity does not require an efficient or even rational purpose. Numerous examples demonstrate otherwise.⁵⁷ And while one might contend that the state concession to the profit corporation is essentially limited to the pursuit of profit⁵⁸ (a purpose subject to objective measurement and therefore arguably not diminished or deval-

56. Pursuant to resource allocation theory in the area of consumer protection, "individuals acting with information adequate to their choice may select for themselves the risks they wish to bear." Shapo, *A Representational Theory of Consumer Protection: Doctrine, Function and Legal Liability For Product Disappointment*, 60 VA. L. REV. 1109, 1375 (1974).

57. Nonprofit corporations may be created for a wide variety of purposes, ranging from public benefit, mutual benefit, sports or recreational purposes, religious purposes, etc. Henn & Boyd, *Statutory Trends in the Law of Nonprofit Organizations: California, Here We Come!*, 66 CORNELL L. REV. 1103, 1108 (1981).

Under the American Law Institute's discussion of corporate governance, shareholders may adopt special purpose charter provisions that reject profit maximization as the corporate goal. ALI DRAFT No. 2, *supra* note 3, at 27. See also R. POSNER, *ECONOMIC ANALYSIS OF LAW* 394 (3d ed. 1986) ("While some people criticize the modern corporation for not trying assiduously enough to maximize profits, others criticize it for making profit maximization its only goal.").

58. The traditional corporate law notion is that the profit of the shareholders is the primary purpose for which a business corporation is organized. Thus, the powers exercised by the directors should further this end. *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 668, 684 (1919); ALI DRAFT No. 2, *supra* note 3, § 2.01 at 25 ("[a] business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."); Weiss, *supra* note 53, at 34.

ued by the imposition of rational external standards), there is no indication that the state requires such pursuit to be pure or unadulterated by the non-pecuniary interests of shareholders.⁵⁹

Even if we ignore shareholder interests other than profit maximization,⁶⁰ the argument for corporate, risk-setting autonomy remains strong.⁶¹ We recognize a variety of intangible goals and values as legitimate to the profit corporation, even those sought at the expense of pecuniary goals.⁶² Community responsibility, employee relations and obligations, loyalty to nation, state, and community, and organizational continuity are examples.⁶³ The most important example, however, because of the wide range of autonomy it implies, is the profit corporation's

59. Indeed, the ALI has recognized that some corporate decisions may be made based on considerations other than profit-maximization. In addition to the primary economic principle noted *supra* at note 57, "the corporation, in the conduct of its business . . . may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and . . . may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes." ALI DRAFT No. 2, *supra* note 3, § 2.01, at 25. Subject to limitations of reasonableness, the ALI would allow corporate decisions based on considerations other than profit-maximization, or even the existence of expected profits. *Id.* at 39. "[O]bservation suggests that corporate decisions are not infrequently made on the basis of ethical considerations even when doing so does not enhance corporate profit or shareholder gain." *Id.* at 36. Desirable social policy seems to mandate that a corporation may not ignore a rule of law simply on the grounds that cost-benefit analysis confirms that corporate gains outweigh the probable costs. Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223, 239 (1983).

See also Weiss, *supra* note 53, at 36-37 (author finds validity in ALI's recognition that more than economic values are at stake in issues of corporate governance).

60. One commentator has observed that "profit maximization is the only goal for which we can at least theoretically posit shareholder unanimity." Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 961 (1984).

61. Disregarding those shareholder interests does emphasize some differences between limiting an individual's and limiting a for-profit corporation's opportunity to choose the levels of risk acceptable to themselves. First, the utilities and disutilities to a corporation, unlike those to an individual, are mostly pecuniary and thereby mostly capable of standardized measurement. A corporation, for example, gains no psychic value from a treasure hunt; the New Jersey expedition will likely not make sense to a corporation *qua* corporation unless it can be pecuniarily justified. To limit the opportunity of individuals to make pecuniarily unjustified investment, however, is to reject the value to them of their legitimate, non-pecuniary goals and interests. To limit a corporation's opportunity to make a pecuniarily unjustified investment denies the corporation nothing (or so it can be argued) other than the peremptory power to assess incorrectly the pecuniary value of the investment.

Secondly, the profit corporation's autonomy, unlike the individual's, is only of instrumental value. This being so, it would follow that the opportunity to engage in activities not furthering corporate objectives can have no independent worth to the corporation.

Finally, the corporation, unlike the individual, is divisible into legally separate parts, and to protect the whole from one of its parts does not necessarily undermine the autonomy of the whole.

62. See *supra* note 59 and accompanying text.

63. The validity of such interests is noted generally in ALI DRAFT No. 2, *supra* note 3, at 29.

prerogative to engage in any lawful enterprise no matter what the balance in risks and rewards (so long as there are potential rewards).⁶⁴ Business corporations may choose to be as risk neutral, averse, or preferring as they please.⁶⁵ Society has demonstrated no interest in affixing outer limits or acceptable ratios to business risk, and this holds true whether the business is conducted by a sole proprietor, a partnership, or a corporation. Indeed, as often noted, many successful business ventures are the product of “unreasonably risky decisions” that fail under the standard negligence formula.⁶⁶ Without deferral to the risk-setting autonomy of corporations, a host of ventures could not be pursued through the corporate form of organization (at least not without regularly exposing their directors to liability).

Thus, to limit the measure and justification of a corporation’s activities solely to pecuniary grounds is to reject both legitimate shareholder interests and the corporation’s ability to define fully, and act upon, its own legitimate interests and aims. Corporate autonomy is both a projection of desirable individual autonomy and a means to, presumably desirable, entrepreneurial diversity.

Still, does it follow that the courts must defer to the decisions of the corporate directors? While the board of directors both is and is not the corporation,⁶⁷ can it be separated for purposes of assessing whether it has exercised the corporation’s risk autonomy with due care? The answer is both yes and no. An unreasonable risk to a particular corporation, as noted earlier,⁶⁸ cannot be determined independently of the utility of the risk to that corporation. The assessment of this utility is normally the function of its directors.⁶⁹ In order to preserve the enterprise’s autonomy

64. Indeed, it is an “accepted role of the corporation as a risk-taking venture.” Cohn, *supra* note 1, at 628. See also Burgman and Cox, *supra* note 5, at 343 (“significant investment risk-taking is part of the nature of the managerial function; shareholder gain is dependent on risk-taking.”).

65. Frankel, *Corporate Directors’ Duty of Care: The American Law Institute’s Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705, 713 (1984) (“The law requires that [directors] set a rational level of the risk, not insure against it. By and large, that level is left to the business judgment of the directors.”) (emphasis added).

66. The concept of a “prudent” person is not desirable in the area of corporate direction. As a matter of public policy, innovation and risk-taking should be highly encouraged. Because many innovative projects will fail, directors must be protected from liability. Manning, *supra* note 17, at 622.

67. The directors exercise most corporate powers, see *supra* note 5, yet are *not* the corporation itself.

68. See *supra* notes 29-30 and accompanying text.

69. See *supra* note 5 and accompanying text.

to establish and pursue acceptable risks, there is no avoiding the authority of its directors, as those who manifest the corporation's will, to establish the corporation's level of acceptable risk. This authority can, of course, be constrained by internally or externally imposed limits. A breach of those constraints would necessarily remove any claim to the protection arising from the exercise of corporate autonomy. Within those constraints, however, directors' actions cannot be regulated without, to the same extent, regulating the corporation.

Judicial intuition of the desirability of corporate risk-setting autonomy and the necessity for its exercise by the directors, is, perhaps, the best, and certainly the most complimentary, explanation for the variety of judicial contrivances which have generally shielded corporate directors from the duty of care. The contrivances, responsive as they are to the need for director discretion, fail to provide meaningful or coherent restraints. They also fail to supply an adequate rationale for further elaboration and development. Moreover, there are crucial differences, as previously noted, between permitting wide latitude for reasonable conduct (e.g., liability only for gross negligence) and deferring to the directors' authority. It is the difference between judicially derived authority and corporate autonomy. It is the difference between the freedom to act only as permitted and the freedom to act except as limited. And the gulf between these two, in practical application, is considerable. It is the difference found in the premises employed for affixing limits. Absent efforts both to address the allocation of authority as between directors' discretion and the law's standards of conduct and to account for these competing authorities and the interests they represent, one cannot be sanguine about the chances for establishing a meaningful and acceptable directors' duty of care.

D. Limits on Discretion

Any direct, judicial resolution of these competing interests would, necessarily, establish limits to an actor's discretionary authority. Discretionary authority is never boundless. Nor are its boundaries one-dimensional. While limits on discretion have not been entirely overlooked,⁷⁰ it is astonishing that the contemporary jurisprudential debate

70. Davis talks about both "confining" and "structuring" discretion. See K.C. DAVIS, *DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY*, 97 (1969). Rogers talks about "exceeding" and "abusing" discretion. See Rogers, *supra* note 47, at 777.

about the role of discretion⁷¹ has focused on discretion's shape without examining its natural borders. Indeed, by establishing the types of limits which might be placed upon discretionary authority we can create an analytical framework for allocating authority between the commands of an actor and the commands of the law.

1. *Contextual Limitations*

An actor's discretionary authority can extend no further than the position, context, or relationship in which his or her authority lies⁷² (best illustrated by a judge's discretionary authority to interpret and apply the law when sitting on the bench but not when driving a car). These limits, which I have chosen to call contextual, will necessarily always be present, and are established by defining the capacity, and the reach of that capacity, in which an actor possesses discretionary authority.

Establishing the contextual limitations for corporate directors appears to be quite straightforward; in other words, establishing whether a director, in a given situation, is acting in that capacity would tend to pose few legal or factual problems. On the other hand, establishing the contextual limits for others, such as parents (e.g., Will the parental capacity be defined to include the operation of a motor vehicle?), appears to present many difficult issues, and may even prove to be the most crucial factor in the determination of their liability.

2. *Scope Limitations*

An actor's discretionary authority, even within the context for which it exists, need not be boundless. These boundaries, which I have chosen to term limitations of scope, can arise from at least three sources: first, laws that otherwise limit the actor's conduct (e.g., antitrust laws); second, legal agreements or charters defining the actor's authority (e.g., a corporate charter's limitations on the authority of directors); and third, the judicially or legislatively established line drawn to fix the appropriate balance between the interests represented by the actor's discretionary authority and the interests protected by the legal duty sought to be imposed (e.g., a rational basis for the actor's conduct).

71. From Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14 (1967), reprinted in *TAKING RIGHTS SERIOUSLY* (London, 1977) through Christie, *An Essay on Discretion*, 1986 DUKE L.J. 747.

72. The contextual limitation is implicit in all discretionary authority. "Jurisdictional" might be a more descriptive term for this limitation, but has not been selected because of its technical usage in the law.

3. *Exercise Limitations*

A third category of limits reflects the potential for conditioning the exercise of discretionary authority on the employment of prescribed procedures or criteria. These limits, which I term limits of exercise, may be subdivided into limits of procedure (e.g., a decision must be informed) and limits of criteria (e.g., race cannot be a factor).⁷³

The sources for exercise limits will be the same as those for limits of scope. Laws may limit the procedures or criteria that can be employed in the actor's particular capacity, private sources for the actor's authority (e.g., by-laws) may do likewise, and judicial deferral to the actor's discretionary authority may very well be conditioned upon a proper exercise of discretion (on the grounds that the basis for deferral to an actor's authority would evaporate without a proper exercise of that authority).⁷⁴

IV. LIMITS OF DISCRETION AND ECONOMIC UTILITY AS JOINT CRITERIA

A. *Standards of Conduct Generally for Directors*

Standard negligence law, no less than corporate law, recognizes that all conduct creates risks of harm and that the objective of the duty of care is to proscribe only conduct creating legally unacceptable risks of

73. The scope and exercise categories can best be illustrated with an example drawn from judicial discretion. Suppose a judge has, by statute, the authority to sentence a convicted felon to the penitentiary for a term of 1 to 20 years. The statute further requires a pre-sentence hearing at which the defendant has the right to be heard, and that the length of the sentence be based upon the defendant's prior convictions and the judge's assessment of the chances for defendant's rehabilitation. These provisions serve as limits to the judge's discretion in that she has no authority, for example, to sentence the defendant to 25 years, or to sentence the defendant to 3 years without first holding a hearing, or to sentence the defendant to 15 years on the basis of the color of her skin. And these are limits on discretion whether or not a higher court has the power to review and reverse—at least limits as to the judge's authority as distinguished from the judge's power.

74. Perhaps we should note here an important difference between the potentials for enforcement of the different limits. Conduct exceeding the limits of context, scope, or procedure will ordinarily be obvious; conduct exceeding the limits of criteria may escape notice unless the actor chooses to declare that criteria upon which he or she acted. Conduct exceeding the limits of criteria may also be identifiable if there exists no rational basis therefor. In his article on judicial discretion of the trial judge, Professor Rosenberg urges that the factors and circumstances that were considered crucial to the discretionary ruling should be placed on the record. Rosenberg, *supra* note 38, at 665. Ironically, "the more a trial judge reveals regarding the reasons for his discretionary ruling, the more vulnerable it becomes." *Id.* at 666. Since a judge is under no duty to identify the criteria, improper criteria are unlikely to be identified.

See also Greenawalt, *Discretion and Judicial Decision: The Elusive Quest for the Fetters that Blind Judges*, 75 COLUM. L. REV. 359 (1975).

harm. Indeed, the function of particularized standards of conduct is to draw that line between acceptable and unacceptable risks. In most duty of care contexts, unacceptable risks are, to a first order of definition, unreasonable risks.

What are unacceptable risks in the context of directors' decisions? Current law, if understood on the basis of when it actually imposes liability (rather than what it declares to be the basis for liability), finds "unacceptable risks" roughly only in those decisions that are irrational or that are the product of a negligent decision-making process.⁷⁵ The first category, irrationality,⁷⁶ constitutes a significant contraction of what is considered unacceptably risky conduct in other duty of care contexts. The second category, focused on the process rather than the resulting conduct, is a significant expansion of unacceptable risks in other duty of care contexts. These departures, assuming the capability to adequately identify in the corporate context the type of conduct which would be classified as creating an unacceptable risk in other areas, do not appear justified. It seems both logical and wise to distinguish, in the corporate context as elsewhere, between the logical and the wise, that is, to recognize that a decision can be unreasonably risky without being irrationally so.⁷⁷ Equally important is the recognition that flawed processes do not automatically produce flawed decisions. A decision made on the basis of, say, the alignment of the stars can be, by chance, rational, reasonable, and sound. Current law for the directors' duty of care, however, does not account for either of these possibilities. This creates two, significant infirmities: first, directors can by their conduct, and without liability, impose any sort of risk on the corporation, no matter how unwise or unreasonable, so long as their conduct is not irrational;⁷⁸ and second, directors may incur liability for otherwise reasonable and sound

75. See ALI DRAFT No. 4, *supra* note 3, § 4.01, reporter's notes 16, 17, at 41-42.

76. Sometimes the term egregious, rather than irrational, is employed, but "egregious" decisions appear to be either irrational or made in bad faith. This latter type of decision is more properly treated as a violation of the director's duty of loyalty.

77. The ALI DRAFT No. 4, *supra* note 4, at 10-11, in common with court opinions concerned with directors' fiduciary responsibilities, employs the distinction by indicating that "rational" permits considerably broader discretion than "reasonable." See generally C. Perelman, *The Rational and the Reasonable*, in RATIONALITY TO-DAY 213-24 (T. Geraets ed. 1979), and Laughlin & Hughes, *The Rational and the Reasonable: Dialectic or Parallel Systems?*, in PRACTICAL REASONING IN HUMAN AFFAIRS 187-205 (J. Golden and J. Pilotta eds. 1986).

78. "[E]ven though a decision made or a result reached is not identical to that of the hypothetical reasonable man, no liability will attach as long as the process by which the result was reached meets the standard." ABA SECTION OF LITIGATION, *supra* note 35, at 9. "A search for cases in

decisions simply because their decision-making process is flawed or inadequate.⁷⁹

Moreover, these departures from standard tort law do not appear to reflect any different policy objectives (e.g., "Let's permit corporate directors to be unreasonable"). The persistent articulation of the "ordinarily prudent" director as the general standard for the corporate duty of care is a strong indication of that. Certainly no persuasive reason has been offered as to why the same policy objectives ought not to be sought for the director's duty of care. The law-and-economics theorists' contention, for example, that directors' fiduciary duties represent that for which the shareholders and directors would contract if transaction costs were not prohibitive,⁸⁰ mandates no change. It is difficult to believe that shareholders would desire a standard of director behavior less than that of an ordinarily prudent person in similar circumstances. The departures produced by current law appear to reflect not a set of different objectives but an inability to formulate standards of conduct which, without inhibiting desirable director behavior, can reach comparable objectives.

A risk becomes unreasonable, i.e., unacceptable, according to standard negligence law, when its magnitude outweighs what the law values as the

which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing will be a relatively fruitless search." *Id.* at 10.

It would seem that irrational board decisions in circumstances where the directors have acted with procedural care are almost certainly a product of fraud or a duty of loyalty violation rather than a failure to act with due care.

79. In *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the directors, who were found to have acted grossly negligently in reaching their judgment as to the fairness of the value of the stock of their corporation (Trans Union) in a cash-out merger, were held liable to the shareholders for the difference between their judgment and "the fair value of the shares . . . based on the intrinsic value of Trans Union." *Id.* at 893. While the outcome in *Van Gorkom* is arguably correct, the leap from negligent process to liability, without a finding that the directors' judgment was itself unreasonable, is a dangerous precedent. For example, what outcome if the directors in *Van Gorkom* had chosen *not* to approve the offer? Moreover, it can be strongly argued that their valuation of the stock was reasonable based on intrinsic value, although significantly different from the valuation others might assign using the same criterion of intrinsic value. Reasonable conduct, that is, conduct not creating unreasonable risks, is rarely so narrow as to be confined to any single decision or course of conduct. Rather, reasonable conduct usually encompasses a range of possible conduct or decisions.

In any event, to impose liability upon directors for the difference in value between their decision and what others might later decide should have been decided, solely because the directors were negligent or grossly negligent in the process of reaching their decision, is to impose liability, oftentimes, for the making of a reasonable decision.

80. See, e.g., Easterbrook and Fischel, *Voting In Corporate Law*, 26 J. OF LAW & ECON. 395, 401 (1983) ("The standby rule of corporate law, the fiduciary principle, requires actors to behave in the way that they would have agreed to do by contract, if detailed contracts could be reached and enforced at no cost.").

utility of the conduct.⁸¹ Note that “the law”, not the actor or the victim, is designated to value the utility of the conduct. A recognition of corporate risk autonomy, as we have seen however,⁸² requires a deferral to the corporate directors’ authority to value the utility of their conduct. That authority has limits, but when acting within those limits directors cannot, by definition, be said to create an unacceptable risk for the corporation. Beyond those limits, however, no reason exists as to why an unacceptable risk should be substantively different from what it is in any other endeavor: a risk of harm whose magnitude outweighs what the law values as the utility of the conduct. These two observations are the key to the development of particularized standards of conduct for corporate directors: first, a requirement that the conduct exceed the boundaries of the directors’ discretionary authority, and second, the additional, but conventional, requirement that the conduct create an unacceptable risk of harm.

To recapitulate, the duty of care for corporate directors seeks to impose no different standard of conduct than it does for others, to-wit, the conduct of an ordinarily prudent person. Because of the risk autonomy accorded to the corporation and exercised by its directors, conduct by directors within the limits of their resulting, discretionary authority is, by definition, reasonable and prudent. However, when the directors act outside the scope of that authority, or when their conduct is not grounded on the exercise of that authority, their actions are to be measured by the law’s usual standards of conduct. In short, directors will not violate their duty of care when acting within the limits of their discretionary authority. When they exceed those limits of authority, then the law should apply its normal tests to determine whether they have created an unacceptable risk of harm to the corporation and thereby violated their duty of care.

The division of the directors’ duty of care into two main areas, breach of discretionary authority and unacceptable risk, opens the way, previously blocked by the admixture of the two, to development of particular-

81. The Restatement defines an unreasonable risk as one in which the magnitude of the harm (possibility of the harm multiplied by the extent and value of the likely harm) “outweigh[s] what the law regards as the utility of the act or of the particular manner in which it is done.” See RESTATEMENT (SECOND) OF TORTS § 291-293 (1965). In Judge Learned Hand’s formulation, “liability depends upon whether B [the burden of adequate precautions] is less than L [the gravity of the injury] multiplied by P [the probability that the injury will occur].” *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

82. See *supra* notes 30-31, 67-69 and accompanying text.

ized standards of conduct. Here, then, might be a logical place to conclude, leaving the development of such standards relating to both risk and authority to the evolutionary processes of the courts and legislatures. However, exploration of the shape these standards might take proves useful, first, by reconfirming, at least indirectly, the validity of the division. Secondly, such exploration demonstrates that particular standards can be developed which are no more difficult to articulate or apply than those employed in typical negligence law. Finally, the exploration offers a sense of the shapes such standards might take.

B. Suggested Standards for Directors' Conduct

The phrase "unreasonable risk of harm", as the *sine qua non* of the breach of a duty of care, generally serves to label the type of conduct which gives rise to liability thereunder. The phrase is, therefore, best reserved for that ultimate meaning. For this and other reasons discussed later,⁸³ I have chosen not to employ that phrase to denominate the second test proposed here. Instead, I describe the second test as a "lack of net economic utility." An "unreasonable risk of harm" in the context of the directors' duty of care is, then, a risk both unauthorized and lacking net economic utility. These two standards can be stated more explicitly as follows: A director will have violated the duty of care when:

(1) The conduct of the director has exceeded the limits of his or her discretionary authority, which limits are established by law and, normally, consist of those that would be recognized by the ordinarily prudent director in a like position and under similar circumstances, and;

(2) The conduct of the director would, to an ordinarily prudent director in a like position and under similar circumstances, lack net economic utility to the corporation, normally manifested by a situation where, as calculated at the time of the conduct in question, the economic costs exceed the economic benefits.

Neither test, standing alone, prescribes a standard of care which, when breached, gives rise to liability. Directors' decisions that can be labelled risk preferring, or that might otherwise project an economically unfavorable cost benefit ratio, do not inherently constitute unreasonable risks to the corporation. To deem such risks unreasonable would, for the reasons already noted,⁸⁴ interfere with the autonomy of the corporation to estab-

83. See *infra* Part IV(B)(2).

84. See *supra* Part III(C)(2).

lish the utility of its own conduct or to reflect legitimate, shareholder interests. At the same time, directors who exceed their limits of discretionary authority do not, thereby, necessarily create unreasonable risks to the corporation. A decision made without adequate information or consideration, for example, may still be a reasonable and prudent decision.⁸⁵ If the decision has net economic utility to the corporation, it cannot be deemed unreasonable or harmful to the corporation except by comparison to the utility of alternative courses of action, and a court cannot make such a comparison without usurping the already-conceded authority of the corporation to establish the utility to it of various lines of activity.

A violation of the two tests will still not result in liability without proof of the traditional and additional elements of causation and harm to the corporation. A decision unauthorized and without net economic utility to the corporation at the time of its making may still result in no harm to the corporation, just as the automobile driver who runs a red light may, by chance, avoid a collision with another car. Our search here is for workable standards to identify unacceptable risks; once identified, those risks must, in addition, produce a loss for liability to result.

1. *The First Test—Exceeding the Limits of Discretion*

Some commentators describe the director's duty of care as more closely resembling a contractual duty than a tort duty.⁸⁶ This description intuits, perhaps, that the corporate directors' duty cannot be breached by simply creating an unfavorable risk to the corporation according to the Learned Hand negligence formula;⁸⁷ also required, seemingly, is a violation of a responsibility attaching to the position of director. Elsewhere, it is observed that alleged breaches of the directors' duty of care appear to be upheld only in cases where there is some proce-

85. The fact that it may later turn sour does not alter the soundness of the original decision. This is the uncorrupted meaning of the business judgment rule.

Moreover, it has long been settled, and for compelling reasons, that it is the decision, not the process or state of mind which produced that decision, which must be measured against the standard of care. See Seavey, *supra* note 36.

86. See Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 888 (1976) ("[I]t is questionable whether the [directors'] duty to use due care or to avoid negligence is a fiduciary duty as distinct from a mere requirement of adequacy of performance or a breach of a contractual or other nonfiduciary duty."); Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

87. See *supra* note 81 for a discussion of the formula.

dural failure by directors, for example, inadequate consideration given to the decision.⁸⁸ Both of these observations lend support to the notion that a breach of the directors' duty of care cannot be based, or at least not identified, solely on the quality or degree of risk inhering in the substance of the directors' decision. Something more is required. That something more, I have already suggested, can be summarized as a breach of the limits of the directors' discretionary authority. Deference to the directors' discretionary authority forbids the application of normal standards of conduct, but conduct beyond the limits of that authority has no such claim to deference.

To establish limits on discretionary authority is to establish the extent to which the judiciary should defer to the idea of corporate autonomy and its exercise by corporate directors. As such, it is a legal, as contrasted with a factual, determination. In assaying those limits, a court would be guided by the corporate interests sought to be protected or promoted by both the duty of care and the directors' discretionary authority. Because those are interests sought in equal measure by a director acting in good faith, the limits of discretionary authority can be generally defined as those that would be recognized by the ordinarily prudent director in a like position and under similar circumstances. This observation is not an idle one, for this embodiment of the overall issue, as with the reasonable person in negligence law, both objectifies and humanizes the key questions in defining the limits of a director's discretionary authority—these questions, not incidentally, closely paralleling those encountered when defining the reasonable person.

The various potential limits to discretionary authority thus provide the grist for forming the particularized standards of conduct uniquely necessary for corporate directors. While the limits that would be recognized by the ordinarily prudent director serve as a general guide, particulars can be developed from the categories of limitations previously described.

a. Contextual Limitations

A director's conduct outside of his or her capacity as director has no basis for claiming special deference. As such, this conduct should be measured against normal standards of care. Current corporate law would do so, and the analytical framework proposed here results in no change.

88. See, e.g., ABA SECTION OF LITIGATION'S COMMENTS, *supra* note 35, at 7.

b. Scope Limitations

The scope of discretionary authority, as previously noted,⁸⁹ can be limited by laws, by rules and agreements internal to the corporation, and by the judicially or legislatively established line drawn to balance the competing interests represented by the duty of care and the directors' discretionary authority. Each of these sources poses a number of issues and offers a variety of options in the choice of limitations.

Should director conduct in violation of a law, or which causes the corporation to violate a law, be considered outside of the directors' discretionary authority? Either alone might not be considered enough. The violation, for example, might be peripheral to the conduct causing the harm (e.g., a procedural violation in the call of a board meeting), or might be a reasonable miscalculation of a statute's or regulation's purport. Moreover, even if the conduct in question is directly and knowingly violative of a law, that conduct need not necessarily be considered beyond the directors' discretionary authority for purposes of their duty of care, for example in situations where the law is immaterial to the protection of the corporation (e.g., the violation of an antitrust law). Indeed, even an unwitting violation of a law enacted to protect the corporation, if made in good faith and believed to be in the best interests of the corporation, is arguably within the directors' discretionary authority.⁹⁰

Where then should the line be drawn for purposes of the directors' duty of care? The problem does not yield answers any more easily than when it is encountered in negligence law generally.⁹¹ Certainly, current law on the directors' duty of care attributes some significance to violations of law.⁹² Keeping in mind that the immediate issue is not whether a law violation constitutes a breach of a director's duty of care but instead whether it amounts to a breach of his discretionary authority, a partial resolution would be to establish the boundaries of discretion parallel to the obligations of the corporation to obey the law. The current tentative recommendation of the American Law Institute⁹³ imposes on corporations no "different obligation to obey the law than that imposed

89. See *supra* Part III(D)(2).

90. For other circumstances where noncompliance with law might be justified, see ALI DRAFT No. 2, *supra* note 3, § 2.01 comment g, at pp. 32-36.

91. See generally PROSSER, *supra* note 4, at § 36.

92. See, e.g., *Miller v. American Tel. & Tel. Co.*, 507 F.2d 759 (3d Cir. 1974). See also Arsht, *supra* note 1, especially at 129-30.

93. ALI DRAFT No. 2, *supra* note 3, § 2.01(a), at 25.

on individuals, [including] exceptions where the norm of obedience to law is usually deemed inapplicable or counterbalanced by other norms.”⁹⁴ A parallel boundary for the discretionary authority of corporate directors would thereby be consistent with corporate obligations and, presumably, with shareholders’ expectations as well.

The discretionary authority of directors would also be limited, it seems, by relevant internal rules and agreements. If, for example, the articles of incorporation limit the areas of directors’ authority, or set forth certain procedures as prerequisites to particular actions, directors’ conduct in violation of such provisions would appear to fall outside of their discretionary authority.

An especially important issue is whether the scope of directors’ discretionary authority should be limited by what might be called the “corporation’s expectations” regarding levels of risks, risk-to-reward ratios, or the utility of particular risks.⁹⁵ The sources for these risk expectations would include the corporation’s purposes, the expectations of its shareholders, its past practices, and the practices of other, similarly-situated corporations. In short, this limitation would require directors’ conduct to fall within the scope of risks contemplated by the corporation. Because the director’s duty of care is victim specific,⁹⁶ an objective standard of conduct in terms of what is customary or expected in the relevant community will be largely irrelevant to the standard that should be imposed on directors of a particular corporation. While customary conduct might serve as evidence of the shareholders’ expectations in the particular corporation, or of what the directors believe them to be, if in fact the corporation’s expectations differ, it would seem that the particular corporation’s expectations should control. If directors act within their corporation’s risk expectations, it seems immaterial what directors of other corporations would do or be expected to do in a like position and under similar circumstances. The particular corporation, it might be said, has accepted as reasonable, or assumed, those risks. If directors act beyond their corporation’s risk expectations, it again seems immaterial what directors of other corporations would do. The particular corporation, it might now be said, has neither assumed nor consented to the risk. In a

94. ALI DRAFT No. 2, *supra* note 3, § 2.01 comment g, at 33.

95. Legal inhibitions on directors, based on shareholder expectations, are not wholly novel, at least in closely-held corporations. *See, e.g., Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1976).

96. *See supra* note 30 and accompanying text.

victim specific tort, the expectations of the potential victim regarding risks or burdens to be borne constitute a valid substitute for standards based on customs or community norms. A breach of those expectations, while not alone enough to create liability, ought to remove any protection from liability normally afforded by the actors' discretionary authority. On the other hand, conduct within those expectations ought to be fully protected.

The final issue in limiting the scope of directors' discretionary authority is whether the law should, regardless of other considerations, draw some outer perimeter. It would seem clear that the scope of directors' discretionary authority ought not to extend beyond rational conduct, i.e., conduct where some "rational business purpose can be attributed" to it.⁹⁷ Equally clear is the error inherent in limiting directors' discretionary authority to "reasonable" conduct. Such a limitation would simply beg the question of discretionary authority and allow for none.⁹⁸ The realistic choice then is between a line drawn at irrational conduct or one drawn somewhere between rational and reasonable, for example at reckless conduct. The sense of current law would favor a line no narrower than irrationality. That is to say, if (and the "if" is important) the corporation wishes to pursue unreasonably high or reckless risks, it should be permitted to do so. While others may be harmed by such unreasonable or reckless conduct (e.g., employees, should the corporation fail), these concerns have not been given as great a regard to date as that extended to enterprise risk autonomy.

In sum, limitations of scope require an inquiry into whether the directors' conduct was (1) irrational (or reckless, if the line is drawn more narrowly), (2) unlawful, (3) in violation of any internal corporate rules or requirements, or (4) outside of the corporation's expectations of directors' discretion regarding risk. Current law, as now articulated, does give attention to the first three, although the consequences of such conduct are often not made clear. A corporation's risk expectations, however, are not a factor in current law, though they would appear to be not only a logical consideration but the most compelling factor in determining whether or not a director's actions should be given special deference.

97. See, e.g., *Panther v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981).

98. A sharp distinction is drawn here between "reasonable" and "rational." See *supra* note 77. For a discussion of the distinction between limits of discretion and the standard of conduct, see generally RESTATEMENT (SECOND) OF TORTS § 895D comment e (1979).

c. Exercise Limitations

Current law on the director's duty of care, as previously noted, elevates the processes and criteria entering into a director's decision to a level of importance otherwise unknown in negligence law. It imposes liability for the consequences of a decision for no other reason than the negligence or gross negligence in the decision's making. Current law is correct, I believe, in attaching importance to the processes and criteria of decision-making, but is mistaken in treating either, with no more, as a violation of the duty of care. A reasonable decision is no less reasonable because of the carelessness that might have gone into its making, nor is an unreasonably risky decision excused simply because the maker was careful in reaching it. However, the processes and criteria do become pertinent in those circumstances where the law has suspended its own judgment and deferred to that of the decision-maker. If the grounds for deferral are ignored or not exercised by the decision-maker, then the basis for judicial deferral is eliminated and the law's normal tests should apply.

The sources for exercise limitations are similar to those for limitations of scope: laws, internal corporate rules, expectations of the corporation, and other judicially imposed obligations. Unlike limitations on scope, however, an outer perimeter of reasonability—reasonable criteria and reasonable processes of consideration—can be imposed without eviscerating the directors' discretionary authority. A range of discretionary authority beyond judicially defined reasonableness is important only as to content, not process. Thus, the level of negligence in the process need not be gross (although such a high level of negligence is understandable if process alone is to serve, as it did in *Smith v. Van Gorkom*,⁹⁹ as the basis for liability). Under the approach here, a breach of exercise limitations only removes the protection of discretionary authority; it does not create liability. Limiting the exercise of discretionary authority to reasonable criteria and processes would seem desirable.

2. The Second Test—Net Economic Utility

I have earlier suggested that once directors breach their discretionary authority, their conduct should be measured against something very close to the normal standard for determining whether or not an actor has created a risk that will give rise to liability. The usual negligence stan-

99. 488 A.2d 858 (Del. 1985). See *supra* note 79 for a discussion of the case.

dard, a risk of harm whose magnitude outweighs what the law values as the utility of the conduct, measures both economic and noneconomic advantages and disadvantages—noneconomic in the sense that the advantages or disadvantages will not result in the production or loss of profit. Thus, the utility of the conduct under the normal standard for measuring “unreasonable risk” includes such benefits as security, loyalty, adventure, patriotism, and morality. However, in the victim specific context of the director’s duty of care, the inclusion of such inherently subjective factors¹⁰⁰ in valuing the utility of directors’ decisions, once discretionary authority has been exceeded, would result in a reinstatement of the original duty of care dilemma, i.e., how to enforce the duty while preserving the directors’ traditional authority to establish for the corporation the utility to it of various lines of action. Directors could simply claim any and all actions to have sufficient noneconomic utility to the corporation as to outweigh all detriments. Reliance on such noneconomic advantages is legitimate, but giving recognition to them without conferring unfettered discretion upon the directors lies at the heart of the duty of care predicament. I have suggested earlier¹⁰¹ that such noneconomic advantages (and disadvantages) ought to be a matter not for the courts but for the directors—so long as they are acting within their discretionary authority.¹⁰² Thereby, questions of whether a noneconomic utility is to be taken into account, and to what extent, are resolved not by judicially established values or standards but by the limits to the authority of the directors. Thereby the noneconomic goals of the corporation and its shareholders, and indeed society,¹⁰³ can be recognized without nullifying the directors’ duty of care.

What then will subject a corporate director to liability if he has ex-

100. For example, the moral advantage to a corporation that its directors might find in resisting a takeover by a foreign corporation. ALI DRAFT No. 2, *supra* note 3, § 2.01 sets forth only pecuniary objectives for a business corporation, yet permits non-pecuniary considerations (e.g., ethical considerations) to be taken into account in the conduct of the business. See generally Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511 (1984).

101. See *supra* Part III(C).

102. See *supra* Part IV(A).

103. One form of utility to society ought not be preferred over another form (e.g., charitable distributions versus shareholder distributions). Moreover, losses to the corporation ought not be justified by benefits to society unless such trade-offs are within the discretionary authority of the directors (e.g., a contribution of half of the corporation’s assets to charity). Thus, the utility of the conduct to society (whether economic or noneconomic) should be considered only in the context of discretionary authority.

ceeded his discretionary authority? The answer, simply, is conduct that would be denominated unreasonably risky in negligence law were the noneconomic factors removed from consideration. Thus translated, it is conduct which imposes economic costs upon the corporation exceeding the economic benefits conferred.¹⁰⁴ (Should the directors exceed their discretionary authority by conduct where all costs and benefits are certain and amount to a net economic loss, we would have the classical case of corporate waste.) Whenever costs or benefits are uncertain, i.e., expected, then, of course, it is necessary that they be discounted by their probability of occurrence. This does not differ from standard negligence law which measures the magnitude of risk in terms of both the extent and likelihood of harm.¹⁰⁵ This formula, like the standard negligence formula, is risk neutral,¹⁰⁶ with considerations favoring risk aversion or risk preference being accounted for in the limits to discretionary authority.¹⁰⁷ Thus, the second test amounts to an application of Learned Hand's negligence formula to the economic advantages and disadvantages to the corporation caused by the conduct in question.

Current law effectively avoids any cost-benefit analysis of the directors' conduct, except insofar as such might be subsumed in a court's determination of the "rationality" of that conduct. This avoidance is, on the one hand, rather surprising since cost-benefit analysis is at the heart of the duty of care (particularly in economic relationships). On the other hand, it is understandable so long as no mechanism has been devised to give recognition to directors' traditional authority. Courts cannot simply ignore this authority and impose liability for, say, all risk-preferring decisions that turn sour. Yet to recognize directors' discretion has, until

104. I would propose the following measures for costs and benefits. For expenditures or investments, the costs would equal the expenditure plus any other directly associated expenses. Benefits would consist of all economic returns to be produced, directly or indirectly, by those costs.

For decisions (or sometimes, non-decisions) declining to make an expenditure or investment, the costs would equal the risk of loss produced, directly or indirectly, by the declination. Benefits would equal the opportunity costs that would have been attributed to the expenditure had it been made.

105. See RESTATEMENT (SECOND) OF TORTS § 293 (1965).

106. See R. POSNER, TORT LAW: CASES AND ECONOMIC ANALYSIS 3 (1982).

107. An indifference between a certain value (i.e., the certain costs less the certain benefits) and an equivalent expected value (i.e., the "sum of the possible benefits . . . multiplied by the probability that the benefits will actually materialize" less the sum of the possible costs multiplied by the probability that they will be incurred) would cast the corporation into a risk neutral posture. (quoted portion from Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 78 (1980)). A preference for the certain value (and a willingness to pay a premium therefor) would constitute a risk averse position; a preference for the expected value (and a willingness to pay a premium therefor) would be a risk preferring position.

now, been to concede nearly unlimited authority. The two-step approach proposed here, which separates discretionary authority and noneconomic factors from the cost-benefit analysis, is a practical and effective way out of the dead-end of current law.

C. Application of the Proposed Standards of Conduct

Application of the proposed standards of conduct could follow much the same pattern as the application of the current business judgment rule and standards of care. Just as conduct that meets the requirements for application of the business judgment rule is fully protected, so too is conduct that falls within the directors' discretionary authority. Questions of undue risk arise under current law, if they arise at all, only after the director fails to qualify for the safe harbor of business judgment. Similarly, the risks and rewards of the conduct need not come into question under the framework proposed here unless it is first established that the conduct falls outside the directors' discretionary authority. Conduct that does fall outside of the directors' discretionary authority can produce liability, but only if it lacks net economic utility to the corporation. Presumably, current law follows a similar pattern in that conduct not protected by the business judgment rule must still be tested for due care (although no test, other than the generalized "care of an ordinarily prudent person," has been articulated).¹⁰⁸

To illustrate the application of the proposed standards of conduct, consider first the uncomplicated situation where the directors of a corporation have caused it to donate X dollars to a particular charity. Under the standards of conduct proposed here, to subject the directors to liability would first require establishing that the directors, either in the content or the process of their decision, exceeded the limits of their discretionary authority. Such a finding could be based, for example, on an unreasonably brief consideration of the decision by the directors, or, for further example, on X dollars exceeding the expectations of the corporation as to the size of charitable giving.¹⁰⁹ If then the directors were found to have violated their discretionary authority, it must further be established that

108. See ALI DRAFT No. 4, *supra* note 3, § 4.01 at 6-7.

109. The criteria for making such a determination would include the corporation's existing circumstances, its past charitable practices, the charitable practices of similarly situated corporations, and generally those expectations of that particular corporation that would be recognized by an ordinarily prudent director in a like position and under similar circumstances. See *supra* notes 95-96 and accompanying text.

their decision, at the time of its making, projected a net economic loss.¹¹⁰ This would require establishing that, to an ordinarily prudent director in a like position and under similar circumstances, the contribution would fail to generate business goodwill or other economic benefits to the corporation equal to or exceeding X dollars plus any other costs associated with the contribution. If, on the other hand, the directors in this example are found to have acted within their discretionary authority, they will not be subjected to duty of care liability no matter how unwise or unreasonable the donation appears to the court. The utility of the donation would be a judgment left to the directors so long as they are acting within their discretionary authority.

Current law offers only a single, process-oriented approach to the above example. No matter how inconceivable and wanting the donation, the directors' conduct will be protected if they meet the motivational and procedural tests of the business judgment rule. On the other hand, if the directors somehow fail to meet those requirements, the outcome would be, at best, unpredictable, and, at worst, result in the imposition of liability without regard to the extent of benefits the donation may have conferred upon the corporation.

As further example, recall the XYZ Corp. whose board decided against the installation of radar on its ocean-going tugs. Decisions declining to expend funds for discretionary items can be expected normally to fall within the directors' discretionary authority, just as they would normally fall within the protection of the business judgment rule. Should the safe harbor of discretionary authority not be available, however, a showing that the decision lacked net economic utility to the corporation at the time of its making¹¹¹ would be required under the approach pro-

110. Directors' decisions, it should be noted, often impose a net economic loss upon the corporation. The purchase of insurance is one such example. Indeed, whenever a premium is paid by the corporation to avoid or to acquire a risk, a cost-benefit analysis, which considers only economic advantages and thereby omits the many non-economic advantages to the corporation of avoiding or preferring a risk, is apt to show a net economic loss. Most of these decisions, however, will be well within the discretionary authority of the directors. Corporations, like people, are risk averse in most activities and willing to pay an economic premium therefor. Given then the expectation of risk averse behavior, few risk-averse decisions, even though failing to produce a net economic benefit, will fall outside the directors' discretionary authority. Directors are subject to duty-of-care liability only when their decisions produce no net economic benefit *and* fall outside of their discretionary authority.

111. The economic costs incurred by the decision (the risks of third-party liability and losses to XYZ's tugs) exceeded the economic benefits otherwise available without such an expenditure, i.e., the opportunity costs of the expenditure.

posed here before that decision could be held to lack due care. This stands in contrast to current law where the measure of due care, once the business judgment rule becomes unavailable, remains anyone's guess,¹¹² if indeed any measure whatsoever is applied. In *Smith v. Van Gorkom*¹¹³ for example, the board's decision approving a proposed merger was found not to be the result of an informed business judgment and therefore outside of the protection of the business judgment rule. The court's next step was simply to "direct that judgment be entered in favor of the plaintiffs and against the defendant directors for the fair value of the plaintiffs' stockholdings [to the extent it exceeded the price of \$55 per share approved by the directors]."¹¹⁴ Thus, the liability of the directors was based solely upon their negligence in the decision-making process, and what followed was simply the application of a rule of damages. While damages would be nominal if the fair value of the plaintiffs' stockholdings was found not to exceed the \$55 per share, nevertheless court costs and plaintiffs' attorney fees would still be imposed on the directors for a decision found to be fair. Moreover, the analytical approach of *Van Gorkom* by omitting the equally critical step of measuring the risk inhering in the conduct, becomes impotent with any other set of facts. What would have been the outcome if, for example, the Trans Union directors had decided *not* to approve the \$55 offer? What would be the outcome if the directors, again absent the protection of the business judgment rule, approved the purchase of an asset which resulted in a net economic benefit to the corporation? What would be the outcome if the directors decided against a recommendation to sell an asset for a price less than the asset's value to the corporation? Just as the violation of a corporate director's duty of loyalty requires a two-part analysis,¹¹⁵ so too, it seems, does the director's duty of care.

Consider next a decision by the directors of a corporation to invest its resources in an ill-conceived venture to explore for gold in New Jersey—an example that can serve to highlight the differences between the safe harbors of business judgment and discretionary authority. The business judgment rule would be available to protect the directors from liability in

112. "Judicial doctrinal discussion of . . . [what legal standard of care governs] is a jumble." Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 3 (1985).

113. 488 A.2d 858 (Del. 1985). See *supra* note 79 for a discussion of the case.

114. 488 A.2d at 864.

115. Conflict of interest and fairness to the corporation. See ALI DRAFT No. 5, *supra* note 3, § 5.01, at 23.

this example so long as, roughly stated, they acted in good faith, were adequately informed, and had some rational basis for their decision. The protection of discretionary authority would not come so easily, requiring a higher degree of accountability. For this venture to fall within the directors' discretionary authority could require under court-developed standards, for example, that the venture be within the contemplation of the corporation.¹¹⁶ If, for instance, the corporation had been organized and theretofore operated to invest in mortgage-debt instruments, the abrupt change in risk assumption represented by this decision could, on that basis, lie outside of the directors' discretionary authority.¹¹⁷

Consider finally any number of actions directors might take to ward off hostile takeovers or unwanted derivative suits. These actions involve inherent conflicts of interest requiring special attention¹¹⁸ which, under current law, has been provided generally through the mechanism of the business judgment rule.¹¹⁹ Moreover, the business judgment rule has been used for resolving such further questions as the authority of directors to employ particular defensive tactics,¹²⁰ the adequacy of the decision-making criteria and process,¹²¹ and the reasonableness of the action taken.¹²² However, the business judgment rule, which at least originally was an expression of the general tort doctrine of unavoidable accident in the business context,¹²³ is merely a judicial hook that brings neither principles, goals, nor structure to the task of resolving these varied issues. The tests capable of development in the form of limits to the directors' discretionary authority and of net economic utility, on the other hand, can separately address each of the above issues within a context of distinct goals and principles. At bottom, whether the goal be to expand or

116. See *supra* notes 95-96 and accompanying text.

117. Keep in mind that a breach of discretionary authority is only the first step toward establishing whether the directors have violated their duty of care.

118. See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. Supr. 1985).

119. *Norlin*, 744 F.2d at 264; *Unocal*, 493 A.2d at 954.

120. See, e.g., *Gearhart Indus., Inc. v. Smith Int'l*, 741 F.2d 707 (5th Cir. 1984) (sale of discounted subordinate debentures with springing warrants); *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981) (creating antitrust problems for an acquirer).

121. See, e.g., *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

122. See, e.g., *Unocal Corp.*, 493 A.2d at 955 ("reasonable in relation to the threat posed").

123. "An unavoidable accident is an occurrence . . . which, under all the circumstances, could not have been foreseen or prevented by the exercise of reasonable precautions." PROSSER, *supra* note 4, at 162. In other words, the mere occurrence of an accident is no proof of negligence, and, in the business context, the mere occurrence of a business judgment proven wrong is no proof of a violation of the duty of care.

contract the directors' duty of care, this capacity constitutes the most important value of the proposed framework and standards.

D. Adapting the Proposed Standards to Current Law

The analytical framework proposed here is readily adaptable to current law. The business judgment rule and the concept of discretionary authority are sufficiently similar as to allow the latter to be incorporated into the former. The business judgment rule has become the artificial device for allowing wide director discretion without developing adequate limits¹²⁴ to the scope of that discretion. However, by incorporating the explicit recognition of discretionary authority, as well as its justification, the business judgment rule can acquire a basis, as well as an analytical framework, for limiting that discretion.

The test for due care has been conceived traditionally as distinct from the test for meeting the business judgment rule.¹²⁵ Nevertheless, the two tests have become blurred¹²⁶ as a result of the inability to develop distinct standards for due care. Under the analytical framework here proposed, the traditional separation of due care standards can not only be maintained but given substance.

V. CONCLUSION

In many respects, current law is similar to the ideas presented here. However, current law has not provided a convincing justification for the special protection it affords directors, nor evolved useful analytical approaches for protecting the corporation as well as the directors. The missing link, it now seems, has been the recognition and separate assessment of discretionary authority. Discretionary authority not only offers an explanation for the special protection afforded directors, but a means by which reasonably to limit that protection. Recognition of discretionary authority is no cure-all; several difficult issues remain, but issues no more numerous or formidable than those encountered regularly in general negligence law. Indeed, the analytical approach proposed here demonstrates, if nothing else, that negligence law—and the duty of care—can accommodate the special situation of the corporate director.

124. Rational, informed, and made in good faith are the typical limits for access to the protection of the business judgment rule. See ALI DRAFT No. 4, *supra* note 3, § 4.01(c) at 6-7.

125. See *id.*

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

