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An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule

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I. INTRODUCTION

For more than two hundred years courts have attempted to define the status and character of corporate directors and officers in an effort to establish and delineate their responsibilities and liabilities. In *Charitable Corp. v. Sutton*,[1] an eighteenth century English case, the Lord Chancellor described corporate directors as both agents and trustees.[2] This mixed characterization was adopted and subsequently persisted in later American cases[3] until

* This Special Project Note is cited as "*An Historical Perspective* (Special Project)" throughout the Special Project.

1. 2 Atk. 400, 26 Eng. Rep. 642 (1742).

2. The court stated:

> I take the employment of a director to be of a mixed nature: it partakes of the nature of a publick office. . . .
>
> Therefore committee-men are most properly agents to those who employ them in this trust . . . .
>
> By accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence . . . and therefore they are within the case of common trustees.

Id. at 504-06, 26 Eng. Rep. at 644-45.

3. Some of the early cases used the terms "agents" and "trustees" almost interchangeably, while others clearly ascribed one label or the other to corporate directors and officers. *See, e.g.*, Smith v. Prattville Mfg. Co., 29 Ala. 503, 507 (1857) (finding that officers "are trustees of the shareholders"); Percy v. Millaudon, 8 Mart. (n.s.) 68, 73-74 (La. 1829) (describing directors as agents who assume a trust for the stockholders); Hun v. Cary, 82 N.Y. 65, 70 (1880) (stating that bank trustees, *i.e.* directors, have the relationship of "agents" to the bank and a relationship similar to "trustees" to the depositors); Hodges v. New England Screw Co., 1 R.I. 312, 340 (1850) (holding directors liable as trustees).

By the end of the nineteenth century at least one writer had observed that courts of law treated directors as agents of the corporation, while equity courts viewed them as trustees of courts finally determined that directors and officers are fiduciaries[4] who have a "distinct legal relationship"[5] with the corporation. As fiduciaries, directors and officers must conform to the duty of care[6] and the duty of loyalty,[7] duties that courts have recognized and imposed since at least the mid-eighteenth century.[8]

II. THE DUTY OF CARE

Perhaps the earliest American case to recognize that directors must exercise due care and diligence in the management of a business was *Percy v. Millaudon.*[9] Since that decision other courts have imposed the same requirement on directors and officers,[10] but have disagreed as to the appropriate standard of care to which di-

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the corporation and the shareholders. *See* S. THOMPSON, LIABILITY OF DIRECTORS AND AGENTS OF CORPORATIONS 351 (1880).

Later cases continued to characterize directors and officers as agents, trustees, or both. *See, e.g.,* Sequoia Vacuum Sys. v. Stransky, 229 Cal. App. 2d 281, 40 Cal. Rptr. 203 (1964); Dixmoor Golf Club v. Evans, 325 Ill. 612, 156 N.E. 785 (1927); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919).

Although courts referred to directors and officers as agents or trustees, they acknowledged that these lahels did not provide an accurate description. *See* Spering's Appeal, 71 Pa. 11, 20 (1872) (recognizing that directors technically are not trustees); *accord Sequoia Vacuum Sys.,* 229 Cal. App. 2d at 287, 40 Cal. Rptr. at 206. Several commentators have stated that although corporate directors and officers possess characteristics similar to agents and trustees, these labels are misnomers to a certain degree. *See, e.g.,* W. GRANGE, CORPORATION LAW FOR OFFICERS AND DIRECTORS 404-05 (1940); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 1.06 (3d ed. 1978); Uhlman, *The Legal Status of Corporate Directors,* 19 B.U.L. REV. 12, 12-15 (1939).

4. *See, e.g.,* Lippitt v. Ashley, 89 Conn. 451, 463, 94 A. 995, 999 (1915); Babineaux v. Judiciary Comm'n, 341 So. 2d 396, 400 (La. 1976); Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939) (holding that directors and officers have a fiduciary relationship with the corporation and its shareholders); Neese v. Brown, 218 Tenn. 686, 693, 405 S.W.2d 577, 581 (1963) (stating that a majority of courts impose a fiduciary duty on directors and officers); *see also* Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement,* 22 BAYLOR L. REV. 157, 161 (1970); Note, *Liability of Directors for Negligent Mismanagement,* 82 U. PA. L. REV. 364, 366 (1934); *cf.* Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980) (indicating that directors are a special type of fiduciary because they always have a degree of personal interest in their corporate undertakings), *cert. denied,* 450 U.S. 999 (1981).

5. Some writers, observing that no one particular term aptly describes a director or an officer, conclude a director stands in a "distinct legal relationship" with the corporation and its shareholders. *See, e.g.,* Uhlman, *supra* note 3, at 16 (quoting 2 MACHEN, CORPORATIONS § 1399 (1908)); Note, *supra* note 4, at 366.

6. *See infra* notes 11-19 and accompanying text.

7. *See infra* notes 115-40 and accompanying text.

8. *See Charitable Corp.,* 2 Atk. at 406, 26 Eng. Rep. at 645 (requiring directors to exercise their trust "with fidelity and reasonable diligence").

9. 8 Mart. (n.s.) 68, 74-75 (La. 1829).

10. *See infra* notes 84-87 and accompanying text (discussing the differences between the duty of care imposed on directors and on officers).

rectors and officers must conform. The various cases analyzing the appropriate degree of care required have produced three basic, but divergent, standards. These three common-law standards, which all include some degree of negligence, are (1) only the degree of care required to avoid gross negligence,[11] (2) the degree of care that an ordinarily prudent director in a like position would exercise under similar circumstances,[12] and (3) the degree of care that an ordinarily prudent person would exercise in conducting personal business affairs.[13] Three states previously did not hold directors and officers liable for any degree of negligence, instead imposing liability only in cases of fraud or intentional misconduct.[14]

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11. *See, e.g.*, Godbold v. Branch Bank, 11 Ala. 191, 200 (1847) (holding that bank directors are liable only for errors "of the grossest kind"); *Percy*, 8 Mart. (n.s.) at 74-75, 78 (concluding that bank directors must devote only "ordinary care and attention" to their jobs in order to avoid making gross errors); *Spering's Appeal*, 71 Pa. at 24 (holding that directors incur liability "for gross inattention and negligence," but not "for mistakes of judgment, even though they may be . . . absurd and ridiculous" as long as the errors were made honestly); *see also* Recent Cases, *Corporations—Officers—Degree of Care Required of Corporate Directors*, 16 MINN. L. REV. 588 (1932) (discussing the various standards of care).

Delaware recently adopted this gross negligence standard. *See infra Recent Developments* (Special Project) notes 66-67 and accompanying text.

12. *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132, 152 (1891); Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963); *Neese*, 218 Tenn. at 694-95, 405 S.W.2d at 581.

13. *See, e.g.*, Burkhart v. Smith, 161 Md. 398, 403, 157 A. 299, 301 (1931); *Hun*, 82 N.Y. at 71; *Hodges*, 1 R.I. at 348; Marshall v. Farmers' & Mechanics' Sav. Bank, 85 Va. 676, 684, 8 S.E. 586, 590 (1889).

Hun stands in sharp contrast to *Spering's Appeal*; both represent major cases at opposite ends of the spectrum concerning the degree of care required of directors and officers. The *Hun* court questioned and rejected the low standard of care articulated in *Spering's Appeal*. Although both courts concluded that ordinary skill and diligence were required, each interpreted this requirement differently. *See, e.g.*, Adkins & Janis, *Some Observations on Liabilities of Corporate Directors*, 20 BUS. LAW. 817, 818-20 (1965). Many scholars have commented on the impact of the two courts' divergent views. *See, e.g.*, Rhoads, *Personal Liability of Corporate Mismanagement*, 65 U. PA. L. REV. 128, 129-44 (1916) (indicating that subsequent Pennsylvania cases moved away from the *Spering's Appeal* position and closer to the *Hun* view).

One commentator has suggested that the differing standards of an "ordinarily prudent man in his own affairs" and an "ordinarily prudent director" have not resulted in any "significant differences in [the] outcome" of cases. Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 344 (1965). Professor Dyson contends that courts actually were referring to the "ordinary director" and that "ordinary care" was the standard applied to all directors. *Id.* at 344-45.

14. *See* Dyson, *supra* note 13, at 371 (discussing the apparent lack of a negligence standard in Kentucky, Tennessee, and Wisconsin); Lewis, *supra* note 4, at 162 (stating that the common law of Kentucky and Wisconsin have not imposed liability on directors unless they act in bad faith and tbat Tennessee adopted the same approach by statute).

Under Tennessee law, bank directors were not liable for any conduct short of "fraud or willful mismanagement" until 1968, when the state legislature enacted the following standard of care for corporate directors and officers: that degree of care "which ordinarily pru-

A majority of the states have codified the common-law duty of care. Most have adopted the "ordinarily prudent director in a like position under similar circumstances" standard.[15] The Model Business Corporation Act (Model Act *or* MBCA) and the Revised Model Business Corporation Act (Revised Model Act *or* Revised MBCA) also embrace this standard.[16] Statutes in other jurisdictions adopt different standards or contain only indirect references to a standard, often in the indemnification part of the state's cor-

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dent men would exercise under similar circumstances in like positions." TENN. CODE ANN. § 48-1-813 (1984). For the earlier version of the law, see TENN. CODE ANN. § 45-218 (1955). Tennessee recently revised its Business Corporation Act; the new Act will become effective in October 1987. The new Act, based on the Revised Model Business Corporation Act, retains the same standard of care enunciated in the 1968 law. *See* TENN. CODE ANN. §§ 48-8-301, 48-1-403 (Supp. 1986).

Apparently, Kentucky and Wisconsin still require bad faith before they will impose liability on directors. *See, e.g.*, Security Trust Co. v. Dabney, 372 S.W.2d 401 (Ky. 1963); Mulder v. Mittelstadt, 120 Wis. 2d 103, 352 N.W.2d 223 (1984); Killen v. State Bank, 106 Wis. 546, 82 N.W. 536 (1900).

Indiana recently amended its statute governing directors' standard of conduct. Directors incur liability for a breach of the duty of care only if they engage in "willful misconduct or recklessness." IND. CODE ANN. § 23-1-35 (Burns Supp. 1986). This language appears to preclude liability for negligence. *See infra Recent Developments* (Special Project) notes 200-05 and accompanying text.

15. State statutes that follow this standard of care include: ALA. CODE § 10-2A-74 (1980); CAL. CORP. CODE § 309 (West 1977); COLO. REV. STAT. § 7-5-101 (1986); CONN. GEN. STAT. ANN. § 33-313 (West Supp. 1986); FLA. STAT. ANN. § 607.111 (West 1977 & Supp. 1986); GA. CODE ANN. § 14-2-152 (1982 & Supp. 1986); HAW. REV. STAT. § 416-91.5 (1985); IDAHO CODE § 30-1-35 (1980); IND. CODE ANN. § 23-1-35 (Burns Supp. 1986); IOWA CODE ANN. § 496A.34 (West Supp. 1986); LA. REV. STAT. ANN. § 12:91 (West 1969); ME. REV. STAT. ANN. tit. 13A, § 716 (West Supp. 1986); MD CORPS. & ASS'NS CODE ANN. § 2-405.1 (1985); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1986); MICH. COMP. LAWS ANN. § 450.1541 (West 1973); MINN. STAT. ANN. §§ 302A.251, 302A.361 (West 1985); MONT. CODE ANN. § 35-1-401 (1985); NEB. REV. STAT. § 21-2035 (1983); N.H. REV. STAT. ANN. § 293-A:35 (Supp. 1986); N.J. STAT. ANN.] 14A]:6-14 (West 1969); N.M. STAT. ANN. § 53-11-35 (1978); N.Y. BUS. CORP. LAW §§ 715, 717 (McKinney 1986); N.C. GEN. STAT. § 55-35 (1982); N.D. CENT. CODE § 10-19.1-50 (1985); OHIO REV. CODE ANN. § 1701. 59 (Anderson 1985); OR. REV. STAT. § 57.228 (1984); PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1986); R.I. GEN. LAWS § 7-1.1-33 (1956); S.C. CODE ANN. § 33-13-150 (Law. Co-op. 1976); TENN. CODE ANN. § 48-1-813 (1984); WASH. REV. CODE ANN. § 23A.08.343 (Supp. 1987). California and Washington also require directors to make a reasonable inquiry into corporate matters.

Effective July 1, 1986, the Delaware statute allows a corporation to eliminate, in its charter, a director's liability for breaches of the duty of care. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1986); *see also infra Recent Developments* (Special Project) notes 206-07 and accompanying text.

16. The Model Act provides that "[a] director shall perform his duties . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." MODEL BUSINESS CORP. ACT § 35 (1978); *see* REVISED MODEL BUSINESS CORP. ACT § 8.30(a) (reprinted *infra Revised Model Act* (Special Project) notes 28 & 35-36 and accompanying text).

poration statute.[17] Some states have not codified a duty of care standard, but have identified certain actions for which directors and officers may be liable.[18] Only a minority of states specifically subject the officers of a corporation, in addition to the directors, to a statutorily imposed duty of care standard.[19]

The modern trend is for courts to demand that directors and officers exercise the degree of care that an ordinarily prudent person in a like position under similar circumstances would exercise.[20] This expression of the standard of care is sufficiently flexible to

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17. *See, e.g.*, KAN. STAT. ANN. § 17-6305 (Supp. 1986) (allowing indemnification for directors and officers who have "acted in good faith and in a manner [they] reasonably believed to be in or not opposed to the best interests of the corporation"); NEV. REV. STAT. ANN. § 78.751 (Michie 1986) (permitting indemnification of directors and officers who act in good faith and in, or at least not opposed to, the best interests of the corporation); OKLA. STAT. ANN. tit. 18, § 1031 (West 1986) (adopting the good faith/reasonable belief standard); TEX. BUS. & COM. CODE ANN. art. 2.41 (Vernon 1980 & Supp. 1986) (stating that directors are not liable for their acts if they exercise ordinary care and act in good faith); VA. CODE ANN. § 13.1-690 (1985) (requiring directors to use good faith business judgment).

Many of the states mentioned *supra* note 15 and *infra* note 18 also have indemnity statutes for directors and officers similar to the Kansas and Nevada statutes.

18. *See, e.g.*, ALASKA STAT. §§ 10.05.216, 10.05.219 (1986); ARIZ. REV. STAT. ANN. § 10-048 (1977); ARK. STAT. ANN. § 64-308 (1980); D.C. CODE ANN. § 29-342 (1981); ILL. ANN. STAT. ch. 32, para. 8.65 (Smith-Hurd 1986); KY. REV. STAT. ANN. § 271A.240 (Michie/Bobbs-Merrill 1981 & Supp. 1986); MISS. CODE ANN. § 79-3-91 (1972); MO. ANN. STAT. § 351.345 (Vernon 1966); S.D. CODIFIED LAWS ANN. §§ 47-5-15—47-5-21 (1983); UTAH CODE ANN. § 16-10-44 (1953); VT. STAT. ANN. tit. 11, § 1891 (1984); W. VA. CODE § 31-1-102 (1982); WIS. STAT. ANN. § 180.40 (West 1957 & Supp. 1986); WYO. STAT. ANN. § 17-1-141 (1977).

Essentially, these statutes provide that directors incur liability if they vote for or assent to: (1) a declaration of dividends or distribution of assets to shareholders contrary to state law or the corporation's charter; (2) the corporation's purchase of its own shares of stock contrary to state statutes; or (3) the distribution of assets to shareholders during liquidation of the corporation without paying or discharging debts and other obligations. Directors presumably assent to these actions unless a dissent is recorded in the corporate minutes. Directors may escape liability if they act in good faith and reasonably rely on financial information provided by the officers in charge of the corporate books or on a written report by a public or certified public accountant. Likewise, other state statutes allow directors to rely on information presented to them by officers or qualified professionals.

19. *See, e.g.*, GA. CODE ANN. § 14-2-152 (1982 & Supp 1986); IOWA CODE ANN. §§ 496A.34, 496A.44 (West Supp. 1986); ME. REV. STAT. ANN. tit. 13A, § 716 (West Supp. 1986); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1986); MICH. COMP. LAWS ANN. § 450.1541 (West 1973); MINN. STAT. ANN. §§ 302A.251, 302A.361 (West 1985); N.Y. BUS. CORP. LAW §§ 715, 717 (McKinney 1986); N.C. GEN. STAT. § 55-35 (1982); PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1986); S.C. CODE ANN. § 33-13-150 (Law. Co-op. 1977); TENN. CODE ANN. § 48-1-813 (1984) (effective October 1, 1987: §§ 48-8-301, 48-8-403).

Perhaps other state statutes omit officers because the jurisdiction's case law only refers to directors or because the legislatures have assumed that the courts will determine and impose the appropriate standard of care on officers.

20. *See* Comment, *Director Liability Under the Business Judgment Rule: Fact or Fiction?*, 35 SW. L.J. 775, 787 (1981). A majority of states have adopted this approach by statute. *See supra* note 15.

apply to a variety of directors and officers who have different responsibilities to the corporation.[21] One justification for the "reasonable director" standard is that if a higher standard were adopted, qualified persons might not accept positions as corporate directors.[22] This argument directly addresses the possibility of qualified individuals declining to serve as outside directors because of potential liability.[23]

Pennsylvania's courts and legislature have vacillated in developing a standard of care for corporate directors and officers. After much fluctuation, however, the law appears to have returned to the standard established by the early common law. In 1872 *Spering's Appeal*[24] enunciated a low standard of care, holding that directors were liable only for "gross inattention and negligence."[25] Subsequent cases initially rejected this approach, considering it to be too lenient.[26] However, a more recent case, *Smith v. Brown-Borhek Co.*,[27] returned to the less demanding standard expressed in *Spering's Appeal*.[28] Like its courts, the Pennsylvania legislature has

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21. *See* Comment, *supra* note 20, at 787. This degree of flexibility is desirable because courts and commentators recognize that the requisite degree of care depends on the facts and circumstances of the particular case. *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132, 147 (1891); Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963); *see also* Lewis, *supra* note 4, at 162.

22. *See* Godbold v. Branch Bank, 11 Ala. 191, 199 (1847); Smith v. Brown-Borhek Co., 414 Pa. 325, 333, 200 A.2d 398, 401 (1964); *see also* W. GRANGE, *supra* note 4, at 407; Miller, *The Fiduciary Duties of a Corporate Director*, 4 U. BALT. L. REV. 259, 271-72 (1975).

23. *See* Miller, *supra* note 22, at 271-72 (stating that without the possibility of indemnification or insurance, outside directors may not be willing to assume the risks associated with a higher duty of care). For a discussion of indemnification and insurance, see *infra Indemnification* (Special Project) and *Insurance* (Special Project).

24. 71 Pa. 11 (1872).

25. *Id.* at 24 (holding that directors are liable for "gross inattention and negligence," but not "for mistakes of judgment, even though they may be . . . absurd and ridiculous").

26. *See, e.g.*, Loan Soc'y v. Eavenson, 248 Pa. 407, 94 A. 121 (1915); Cornell v. Seddinger, 237 Pa. 389, 85 A. 446 (1912); *see also* Rhoads, *supra* note 13, at 135-38 (discussing the evolution of early Pennsylvania case law); Uhlman, *The Duty of Corporate Directors to Exercise Business Judgment*, 20 B.U.L. REV. 488, 495 n.28 (1940) (stating that "[t]he rule of [*Spering's Appeal*] has disappeared for all practical purposes").

27. 414 Pa. 325, 200 A.2d 398 (1964).

28. The *Brown-Borhek* court acknowledged the higher standard of care required by Pennsylvania's state statute, *see infra* note 29, but emphasized that "[f]rom an early date the Court has consistently recognized the danger of subjecting corporate directors to liability whenever any of the transactions of the company did not meet with success." *Brown-Borhek*, 414 Pa. at 333, 200 A.2d at 401.

A later case, Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634 (1966), distinguished *Brown-Borhek* and followed the Pennsylvania statute's higher standard of care of "an ordinary prudent person managing his own personal affairs." After *Selheimer* the Pennsylvania legislature amended the state's corporation statute and adopted the less rigorous standard of "a reasonable director." *See infra* notes 29-30 and accompanying text.

wavered over the appropriate standard for the duty of care. When the legislature originally codified the duty of care in 1933, it adopted a stringent standard requiring the degree of care exemplified by an ordinarily prudent person in the management of personal business affairs.[29] In 1968, however, the legislature apparently concluded that this burden was too heavy and enacted the less rigorous "ordinarily prudent person in a like position under similar circumstances" standard.[30]

Because confusion and diversity abound over which standard should be employed to determine a director's duty of care to the corporation, at least one commentator has suggested that different standards should apply to different types and sizes of corporations.[31] This suggestion is supported by a great body of case law which concludes that, in matters of care and diligence, each case must be decided based on its particular facts and circumstances.[32] Another commentator suggests that only two elements are necessary to satisfy a reasonable standard of care: (1) "alertness to potentially significant corporate problems;" and (2) "deliberative decisionmaking on issues of fundamental corporate concern."[33] Alertness to corporate problems demands only ordinary care and

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29. PA. STAT. ANN. tit. 15, § 2852-408 (Purdon 1967).

30. *Id.* § 1408 (Purdon Supp. 1986).

Even after this legislative amendment, the Pennsylvania courts rendered varied opinions regarding the standard to impose on directors. In 1974 a federal district court, employing Pennsylvania law, applied the older and harsher statutory standard and cited the 1933 statute. *See* Bellis v. Thal, 373 F. Supp. 120, 123 (E.D. Pa. 1974), *aff'd*, 510 F.2d 969 (3d Cir. 1975). The court acknowledged that this was "a higher duty of care . . . than [that imposed by] the common law" of Pennsylvania. *Id.* Nevertheless, the defendants in this case were found not liable because the plaintiffs failed to prove proximate cause. For a discussion of proximate cause, see *infra* notes 47-48 and accompanying text. Another federal district court subsequently applied the current statutory standard of care. *See* United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 583-84 (M.D. Pa. 1983).

31. *See* Lynch, *Diligence of Directors in the Management of Corporations*, 3 CALIF. L. REV. 21, 28-29 (1914). Mr. Lynch suggested that classifying corporations by type or size would lead to more realistic rules governing the standard of care for directors. His suggestions for appropriate groupings are "(a) ordinary manufacturing, mining, or trading corporations; (b) monied corporations, as banks or insurance companies; (c) public service corporations; [and] (d) charitable, educational, or religious corporations." *Id.*

Another author argues that courts may reach divergent results in cases with essentially the same facts, depending on whether the directors and officers are associated with a large or a small corporation. *See* M. FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 35-36 (2d ed. 1974).

32. *See, e.g.*, *Briggs*, 14 U.S. at 147; *Allis-Chalmers*, 41 Del. Ch. at 84, 188 A.2d at 130; Hun v. Cary, 82 N.Y. 65, 71 (1880); Neese v. Brown, 218 Tenn. 686, 693, 405 S.W.2d 577, 581 (1963).

33. 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, 613 (1983).

attention to corporate matters, but the degree of alertness depends on the circumstances and the particular business in which the corporation engages.[34] Deliberative decisionmaking requires obtaining adequate information and employing this information to make a rational business decision.[35] According to this commentator, courts are more likely to delve into the degree of care and attention directors and officers devote to business matters than into the decisionmaking process itself.[36]

All courts agree that directors and officers must act with some degree of diligence and care,[37] but the various formulations of the duty of care are vague and provide little guidance regarding the particular conduct required of directors and officers. Some courts and commentators have suggested basic, but not necessarily exhaustive, expectations of directors and officers.[38] Among these postulations are that directors should supervise corporate expenditures,[39] disburse corporate funds appropriately,[40] keep themselves informed of the corporation's affairs,[41] attend board meetings,[42] and reasonably supervise officers and managers.[43] No jurisdiction, however, expects directors, especially outside directors,[44] to bear

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34. *Id.* at 613-15.

35. *Id.* at 615-26.

36. *Id.* at 613-27. Instead of inquiring too deeply into the decisionmaking process, courts generally find "refuge in the business judgment rule." *Id.* at 617. For a discussion of the business judgment rule, see *infra* notes 50-77 and accompanying text.

37. The primary disagreement concerns the standard to which directors and officers should be held. *See supra* notes 11-14 and accompanying text.

38. *See infra* notes 39-46 and accompanying text.

39. *See, e.g.,* Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634 (1966); M. FEUER, *supra* note 31, at 33.

40. *See* Rapoport v. Schneider, 29 N.Y.2d 396, 278 N.E.2d 642, 328 N.Y.S.2d 431 (1972).

41. *See* Barnes v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924); Cohen v. Cocoline Prods., Inc., 309 N.Y. 119, 123, 127 N.E.2d 906, 907 (1955); Francis v. United Jersey Bank, 87 N.J. 15, 32, 432 A.2d 814, 822 (1981); M. FEUER, *supra* note 31, at 33-35; W. GRANGE, *supra* note 3, at 410; *Corporate Director's Guidebook,* 33 BUS. LAW. 1591, 1602 (1978) [hereinafter *Guidebook*].

42. *See* Williams v. Brady, 232 F. 740, 744 (D.N.J. 1916); W. GRANGE, *supra* note 3, at 408-09; *Guidebook, supra* note 41, at 1602.

43. *See Briggs,* 141 U.S. at 147, 165; Lippitt v. Ashley, 89 Conn. 451, 473, 94 A. 995, 1003 (1915); *Allis-Chalmers,* 41 Del. Ch. at 84-85, 188 A.2d at 130; W. KNEPPER, *supra* note 3, § 5.01; Lewis, *supra* note 4, at 165.

44. *See, e.g.,* Rowen v. Le Mars Mut. Ins. Co., 282 N.W.2d 639, 652-53 (Iowa 1979) (stating that "[a]n outside director is usually defined as one who is neither an officer nor an employee of the corporation" and that outside directors "should [not] substitute their judgment for that of those in active control of decision making"); Cohn, *supra* note 33, at 609 (iterating that outside directors cannot be "primary decisionmakers"); Hahn & Manzoni, *The Monitoring Committee and Outside Directors' Evolving Duty of Care,* 9 LOY. U. CHI. L.

the entire burden of operating a corporation. Directors have discretion to delegate the actual operation of the corporation to management.[45] Likewise, directors generally can rely on financial reports and other information supplied by officers, employees, outside professionals, and board committees.[46]

When forced to assess a director's or officer's liability for violating the duty of care, a court initially considers whether the director or officer actually violated the duty of care and then considers whether the director's or officer's conduct proximately caused the alleged harm or loss to the stockholders or corporation.[47] If the director's or officer's behavior was not the proximate cause of the injury, no liability will attach.[48] The burden is on the party alleging harm to prove that but for the director's or officer's dereliction of duty, the loss would not have occurred.[49]

III. The Business Judgment Rule

The business judgment rule developed concurrently with the duty of care.[50] In fact, the cases in which courts originally articulated the duty of care also discussed the business judgment of directors and officers.[51] Many of these early cases simply stated that

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J. 587, 614 (1978) (stating that outside directors delegate operational functions to management).

45. *See Briggs*, 141 U.S. at 163, 165; W. KNEPPER, *supra* note 3, § 5.01; *Guidebook*, *supra* note 41, at 1603.

46. *See Allis-Chalmers*, 41 Del. Ch. at 85, 188 A.2d at 130 (stating that directors can rely on others and have "no duty . . . to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists"); W. GRANGE, *supra* note 3, at 407; *Guidebook*, *supra* note 41, at 1602-03; *see also supra* note 18.

47. *See* Bellis v. Thal, 373 F. Supp. 120, 124 (E.D. Pa. 1974), *aff'd*, 510 F.2d 969 (3rd Cir. 1975) (holding that directors' and officers' breach of duty must proximately cause harm to the corporation before liability will be imposed); Barnes v. Andrews, 298 F. 614, 616 (S.D.N.Y. 1924) (deciding that a plaintiff must not only prove that a director neglected the duty of care, but also that the director's negligence caused the loss); Comment, *supra* note 20, at 789.

48. *See* Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924) (finding the defendant-director not liable despite his breach of the duty of care because the evidence did not prove that the defendant-director caused the loss or could have prevented it); *cf. Lippitt*, 89 Conn. at 475, 94 A. at 1003 (holding bank directors liable for losses proximately caused by their failure to supervise and oversee bank operations).

49. *See Barnes*, 298 F. at 616.

50. *See* Cohn, *supra* note 33, at 603.

51. *See, e.g.*, Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829) (holding that directors are liable only for business mistakes "of so gross a kind that a man of common sense, and ordinary attention, would not have [committed them]"); *Hun*, 82 N.Y. at 74 (noting that a director must "exercise ordinary skill and judgment . . . [and that] [w]hen damage is caused by his want of judgment, he cannot excuse himself by alleging his gross ignorances"); *Spering's Appeal*, 71 Pa. at 24 (concluding that directors "are not liable for mistakes of

directors and officers were not liable for honest mistakes or errors of judgment.[52] Other cases held that directors and officers incurred liability only for errors "of the grossest kind."[53] Several courts and commentators have articulated their own formulations of the business judgment rule.[54] The rule basically states that if any rational business purpose exists for directors' or officers' decisions, they are not liable for errors in judgment when their decisions result in an unfavorable outcome for the corporation.[55] The modern expression

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judgment").

52. *See, e.g.*, Smith v. Prattville Mfg. Co., 29 Ala. 503, 509 (1857); *Hun*, 82 N.Y. at 70; Hodges v. New England Screw Co., 1 R.I. 312, 348 (1850).

53. *Godbold*, 11 Ala. at 200; *see also Percy*, 8 Mart. (n.s.) at 78. *But cf.* Spering's Appeal, 71 Pa. 11, 24 (1872) (concluding that directors are not responsible for even "absurd and ridiculous" errors of judgment if they are made honestly and "within the scope of the [directors'] powers").

54. One court defined the business judgment rule as follows:

> When [directors] act in good faith, tbey enjoy a presumption of sound business judgment . . . which courts will not disturb if any rational business purpose can be attributed to their decisions. In the absence of fraud, bad faitb, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.

Panter v. Marshall Field & Co., 486 F. Supp. 1168, 1194 (N.D. Ill. 1980).

In an earlier decision, another court proffered a sinilar synopsis of the business judgment rule:

> If in tbe course of management [directors] arrive at a decision for which there is a reasonable basis, and they act in good faith, as the result of their independent judgment, and uninfluenced by any consideration other than what they honestly believe to be for the best interests of the [corporation], it is not the function of the court to say that it would have acted differently and to charge the directors for any loss or expenditures incurred.

Casey v. Woodruff, 49 N.Y.S.2d 625, 642-43 (1944).

One commentator proposed the following as a comprehensive statement of the business judgment rule:

> A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, unless:
>
> (1) the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or
>
> (2) the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or
>
> (3) in some other way the directors' authorization of the transaction was not in good faith.

Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111-12 (1979).

55. *See, e.g.*, *Casey*, 49 N.Y.S.2d at 642-43 (stating that directors do not incur liability when they exercise reasonable business judgments that later prove to be "faulty"); Otis & Co. v. Pennsylvania R. R., 61 F. Supp. 905, 911 (E.D. Pa. 1945) (noting that "mistakes or errors in the exercise of honest business judgment do not subject the officers and directors to liability for negligence in the discharge of their appointed duties").

of the rule essentially follows the reasoning applied in some of the early cases[56] and absolves directors of liability for acts short of gross negligence or fraud.[57] This assumes, of course, that the directors and officers actually have exercised business judgment.[58] Some courts even have by-passed the traditional duty of care analysis and proceeded directly to an application of the business judgment rule.[59]

The issue arises of whether the business judgment rule has supplanted the duty of care. At least one commentator suggests that currently the primary inquiry is whether directors and officers actually exercised business judgment.[60] If directors and officers exercise business judgment, some courts will not delve further into the matter because these courts presume that directors and officers exercised reasonable care and diligence during the decisionmaking process.[61] Given this presumption, can the business judgment rule

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56. *See, e.g.*, Goldbold v. Branch Bank, 11 Ala. 191, 200-01 (1847) (asserting that "bank directors are not responsible for errors of judgment, unless the error be of the grossest kind"); *Prattville Mfg. Co.*, 29 Ala. at 508 (indicating that when directors and officers exercise business judgment, courts will not interfere unless their judgment is "a willful abuse of their discretion, or the result of bad faith, or of a willful neglect or breach of a known duty").

57. *See, e.g.*, Gimbel v. Signal Cos., Inc., 316 A.2d 599, 609 (Del. Ch. 1974) (finding that "the business judgment rule weighs in favor of the directors' decision . . . unless the complaining shareholders can prove fraud or a clearly inadequate sale price"); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. Super. Ct. 1971) (stating that "a court will not interfere with the judgment of a board of directors unless there is a showing of gross and palpable overreaching"); *see also* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095 (1968) (stating that liability for "mere negligence" is rare). *But see Casey*, 49 N.Y.S.2d at 643 (indicating that the somewhat higher standard of "reasonable diligence" applies).

58. *See Gimbel*, 316 A.2d at 609 (stating that the business judgment rule has no applicability unless "informed directors did, in fact, make a business judgment"); Hun v. Cary, 82 N.Y. 65, 74 (1880) (holding that errors of judgment are not excused by "gross ignorance" and that directors must "exercise proper care and diligence").

59. *See, e.g.*, Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) (eliminating any due care analysis by holding that the business judgment rule required the plaintiffs to "prove fraud or . . . oppressive conduct").

60. *See* Cohn, *supra* note 33, at 594 (asserting that courts now initially inquire into whether directors exercised their business judgment rather than first considering whether they met the requisite duty of care).

Another commentator predicts "that the distinction between the business judgment rule and the negligence rule [*i.e.*, duty of care] . . . which is already somewhat obscure, will largely vanish." Cary & Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 70 (spec. issue 1972) (comments by Professor Cary).

61. *See, e.g.*, *Gimbel*, 316 A.2d at 608-09; *Sinclair Oil*, 280 A.2d at 720 (noting that "[a] board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose").

co-exist with the duty of care, or does the rule override this duty? At least one case[62] explicitly asserts that no conflict exists between the two requirements.[63] Other cases indicate that the business judgment rule supersedes even the need to consider the duty of care.[64] In its pure form, however, the business judgment rule should be applied only after ascertaining whether the directors and officers actually made a business decision and, if so, whether they exercised the requisite degree of care during the decisionmaking process.[65] If the directors and officers exercised appropriate care, but their judgment proves to be faulty, courts should determine whether the directors and officers made a business decision that they honestly believed to be within their authority and in legitimate furtherance of the corporation's best interests.[66] If so, the business judgment rule should be applied and no liability should attach.[67]

Courts and commentators have posited various rationales for the viability of the business judgment rule. Three primary justifications are that (1) directors and officers are not infallible,[68] (2) competent directors would not accept directorships without some assurance of protection for mistakes,[69] and (3) courts have neither the ability nor the desire to substitute their judgment for that of more experienced professionals.[70] Adherence to the business judg-

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62. Casey v. Woodruff, 49 N.Y.S.2d 625 (1944).

63. The *Casey* court stated:

> [H]ow does the operation of the . . . "business judgment rule" tie in with the concept of negligence [*i.e.*, the duty of care]? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in tbe conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.

Casey, 49 N.Y.S.2d at 643.

64. *See, e.g., Gimbel*, 316 A.2d at 608-09; *Sinclair Oil*, 280 A.2d at 720.

65. *See Guidebook, supra* note 41, at 1604.

66. *See* Arsht, *supra* note 54, at 114; Cohn, *supra* note 33, at 604.

67. *See* Arsht, *supra* note 54, at 119-20.

68. *See* Beach v. Williamson, 78 Fla. 611, 620, 83 So. 860, 863 (1919) (asserting that a director "is not supposed to be infallible, and does not stipulate against error"); Scott v. Depeyster, 1 Edw. Ch. 513, 535 (N.Y. Ch. 1833) (finding that a director or officer "is not supposed to have attained infallibility").

69. *See Percy*, 8 Mart. (n.s.) at 78; *Brown-Borhek*, 414 Pa. at 333, 200 A.2d at 401 (stating that directors "would rarely ever accept a directorship if they could be held liable for every 'bad' account or every mistake of judgment"); *Spering's Appeal*, 71 Pa. at 21.

70. *See* Karasik v. Pacific Eastern Corp., 21 Del. Ch. 81, 97, 180 A. 604, 611 (1935)

ment rule protects directors and officers who assume the necessary risks inherent in the operation of a corporation.[71] Individuals with desirable skills and ability, therefore, are more likely to assume the responsibilities of a directorship if they do not fear a lawsuit each time a decision, in hindsight, proves to be improvident.[72]

The business judgment rule provides significant protection to directors and officers. Courts, however, have limited the rule to ensure that directors and officers will not automatically escape liability for all possible actions. Courts will not apply the rule and exempt a director from liability if fraud,[73] illegality,[74] gross negligence,[75] or a conflict of interest[76] exists. Thus, directors and

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(holding that courts will not substitute their judgment for that of directors and officers in cases of "mere mistake"); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928) (concluding that, absent fraud, directors' decisions are final and a court's role is not to resolve business disputes); Auerbach v. Bennett, 47 N.Y.2d 619, 630-31, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926-27 (1979) (emphasizing that one justification for the business judgment rule is that directors are qualified to make business decisions while "courts are ill equipped" to do so); *Guidebook, supra* note 41, at 1604.

71. *See* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978) (indicating that tbe business judgment rule affords directors wide discretion in managing "corporate affairs"), *cert. denied,* 439 U.S. 1129 (1979); M. FEUER, *supra* note 31, at 37 (stating that "[t]he very nature of managing business enterprises for profit requires continuous risk-taking and . . . [t]o apply an unduly rigorous standard of care might dilute the incentive to aggressive action wbich bas been a necessary condition for the success of American capitalism").

72. *See* Dyson, *supra* note 13, at 367.

73. *See, e.g.,* Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 658-60 (Del. Ch. 1975) (finding that directors had discretion regarding the timing of dividend payments and that their decision to delay payment should not be questioned by the court unless the plaintiff showed "fraud or gross abuse of discretion"); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971) (holding that the business judgment rule applies absent a showing of fraud, bad faith, or reckless conduct by directors); Kors v. Carey, 39 Del. Ch. 47, 54-55, 158 A.2d 136, 141 (1960) (stating tbat directors' business judgment will not be questioned unless the plaintiffs prove fraud or other misconduct).

74. *See, e.g.,* Abrams v. Allen, 297 N.Y. 52, 55-56, 74 N.E.2d 305, 306 (1947) (holding that directors may incur liability if they use corporate property for an illegal purpose).

75. *See, e.g.,* Muschel v. Western Union Corp., 310 A.2d 904, 908 (Del. Ch. 1973) (stating that the court would not intervene in a suit to enjoin a merger for alleged inadequacy of price unless the disparity of the selling price and the value of the assets was so great that directors must have acted recklessly or in bad faith); Warshaw v. Calhoun, 43 Del. Ch. 148, 157, 221 A.2d 487, 492-93 (1966) (stating that courts will interfere only if directors act in bad faith or grossly abuse their discretion); Swenson v. Thibaut, 39 N.C. App. 77, 107, 250 S.E.2d 279, 298 (1978). *But see* Everett v. Phillips, 288 N.Y. 227, 232, 43 N.E.2d 18, 19-20 (1942) (noting that even gross errors of judgment can be excused).

76. *See, e.g.,* Western States Life Ins. Co. v. Lockwood, 166 Cal. 185, 193, 135 P. 496, 499-500 (1913) (finding that the good faith of the corporation's director-president, who entered into a contract for secret profits, did not protect him from liability when he acted adversely to the corporation's interests); Schreiber v. Pennzoil Co., 419 A.2d 952, 956 (Del. Ch. 1980) (stating that "[t]he business judgment rule is a presumption that a rational business decision of tbe officers or directors of a corporation is proper unless there exists [sic]

officers are not completely immune from suit and must account for their decisions when they overstep the bounds of the business judgment rule.[77]

In addition to overcoming the presumption that directors and officers have exercised business judgment, plaintiffs also bear the burden of proving that the business judgment rule is inapplicable.[78] If the plaintiffs meet their burden of proof and establish that self-dealing or other conflicts of interest operate to remove the protection of the rule, the burden shifts to the director or officer to prove the fairness of the transaction.[79]

IV. A Comparison of Various Types of Directors and Officers

State statutes and case law require directors and officers to conform to some standard of care in performing their corporate responsibilities. That standard, however, may vary among jurisdictions depending on several distinct factors, including the type of corporation, the position held by the director or officer, and how much negligence the jurisdiction will tolerate.[80] In addition, numerous courts and scholars have discussed the distinctions between directors and officers,[81] inside and outside directors,[82] and

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facts which remove the decision from the protection of the rule—such as self-dealing, conflict of interest, etc.").

77. Although many courts recite various limitations on the business judgment rule, few actually find that directors' or officers' actions fall within these limitations. Thus, the rule often shields directors and officers from liability except in egregious cases of misconduct. *See, e.g.*, Western States Life Ins. Co. v. Lockwood, 166 Cal. 185, 135 P. 496 (1913) (holding director liable for obtaining secret profits).

78. *See* Arsht, *supra* note 54, at 130-33 (explaining that the presumption in favor of directors' and officers' business judgment is rebuttable, but places the burden on the plaintiff to disprove the business judgment rule defense); *see also* Marks v. Wolfson, 41 Del. Ch. 115, 127, 188 A.2d 680, 685 (1963) (holding that in a minority stockholders' challenge to the price for the sale of corporate assets, the plaintiffs have the burden of proving that the directors acted in bad faith); Gropper v. North Cent. Texas Oil Co., 35 Del. Ch. 198, 202, 114 A.2d 231, 233 (1955) (finding that in a challenge to the sufficiency of a proxy statement to ratify the sale of assets, directors are presumed to have exercised business judgment "honestly and in good faith," and that the plaintiffs have the burden of proving an unfair contract unless fraud is present); *cf. Bellis*, 373 F. Supp. at 124 (finding that, in an arm's length transaction, the plaintiffs have the burden of proving that the "defendants breached their duty and that the conduct complained of was not fair or in the interest of the corporation").

79. *See infra* notes 131-32 and accompanying text.

80. *See supra* notes 11-19 and accompanying text.

81. *See infra* notes 84-92 and accompanying text.

82. *See infra* notes 93-106 and accompanying text.

bank directors and other corporate directors.[83]

Although directors and officers have similar fiduciary obligations to the corporation and to its shareholders,[84] some courts hold officers to a higher degree of care than directors.[85] This variance in the requisite degree of care arises from the dichotomy between directors' and officers' duties.[86] Officers assume responsibility for the daily operation and management of a corporation.[87] Conversely, the board of directors advises management[88] and formulates corporate policy,[89] with little or no direct involvement in the corporation's daily operations.[90] While directors in small corporations often exercise significant control over the affairs of the corporation, directors in large, publicly held corporations generally are removed from the management of the corporation.[91] In addition, directors usually can rely on officers' reports concerning finances and other

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83. *See infra* notes 107-14 and accompanying text.

84. *See* W. GRANGE, *supra* note 3, at 444-45.

85. *See, e.g.*, Bates v. Dresser, 251 U.S. 524, 529-31 (1920) (concluding that the president would be held to a greater degree of care because he controlled the bank's business affairs, and holding the director, who had less involvement with the daily business operations, not liahle); Raines v. Toney, 228 Ark. 1170, 1178, 313 S.W.2d 802, 808 (1958) (stating that "[t]he law imposes a high standard of conduct upon an officer or director of a corporation," hut imposes "[e]ven a higher standard of duty" on one who is a vice-president, director, and manager of a hank); San Pedro Lumber Co. v. Reynolds, 121 Cal. 74, 81-82, 53 P. 410, 412 (1898); Masonic Bldg. Corp. v. Carlsen, 128 Neh. 108, 131-32, 258 N.W. 44, 55 (1934).

As illustrated in *Bates*, the president of a bank may be held to an even higher standard of care than other directors and officers because the president assumes the greatest burden in managing the bank. *See* Brown v. Farmers & Merchants Nat'l Bank, 88 Tex. 265, 275, 31 S.W. 285, 288 (1895) (stating that directors elect the president, who "has great influence upon the policy of the [bank] and the conduct of the various employes [sic] in the discharge of their duties").

86. *See* Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U.L. REV. 1341, 1343 (1977); Mace, *The President and the Board of Directors*, HARV. BUS. REV., Mar. - Apr. 1972.

87. Soderquist, *supra* note 86, at 1343; Mace, *supra* note 86, at 37.

88. *See* Mace, *supra* note 86, at 37. According to Professor Mace, the role of the board of directors is largely advisory and not of a decisionmaking nature.

89. *See* Graham v. Allis-Chalmers, 41 Del. Ch. 78, 85, 188 A.2d 125, 130 (1963) (noting that modern corporate directors "confine their control to the broad policy decisions").

90. *See, e.g.*, Barnes v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924) (stating that "directors are not expected to interfere individually in the actual conduct [of the corporation's affairs]"); Lowell Hoit & Co. v. Detig, 320 Ill. App. 179, 181-82, 50 N.E.2d 602, 603 (1943) (holding that directors, by "necessity," must delegate much authority to subordinates).

91. *See* REVISED MODEL BUSINESS CORP. ACT § 8.01 official comment at 195 (1985) (recognizing that in large, publicly held corporations "it is not feasible to impose a requirement that the business and affairs of the corporation be managed 'by' the board of directors . . . since the role of the board of directors consists principally of the formulation of major management policy with little or no direct involvement in day-to-day management").

selected matters.[92] Officers, therefore, are held to a higher duty of care regarding the preparation and analysis of information presented to the board of directors.

Courts and commentators emphasize the distinctions between inside and outside directors more often than they distinguish between directors and officers.[93] When differentiating between inside and outside directors, courts hold inside directors to a higher standard of care because they participate more fully in the daily operations of the corporation.[94] The assumption, therefore, is that inside directors have more knowledge and awareness of the management of the corporation.[95] Conversely, outside directors have less time to devote to the daily operations of the corporation.[96] Another justification for this differentiation is that corporations could not attract qualified people to outside directorships if they were as accounta-

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92. *See* M. FEUER, *supra* note 31, at 27. State statutes generally allow directors to rely on reports of officers and other specific individuals. The California statute, for example, provides as follows:

> [A] director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:
>
> (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented,
>
> (2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or
>
> (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence. . . .

CAL. CORP. CODE § 309(b) (West 1977); *see also infra* note 98.

93. Inside directors are corporate officers or employees. Some directors do not fit neatly into the broad categories of "inside" and "outside" directors. For example, the corporation's legal counsel, the corporation's banker, retired executives of the corporation, and representatives of major suppliers or customers of the corporation blur the inside-outside director distinction. *See* Rowen v. Le Mars Mut. Ins. Co., 282 N.W.2d 639, 652 (Iowa 1979).

94. *See* Bynum v. Scott, 217 F. 122, 125 (E.D.N.C. 1914) (stating that "[w]hen . . . a director is also president and secretary of the corporation, and assumes the actual and sole active management of the business . . . a very much higher degree of care is required" than for non-officer directors); *see also* W. KNEPPER, *supra* note 3, § 1.09 (noting that "inside directors who are also corporate officers are usually the real managers of the organization"); Soderquist, *supra* note 86, at 1351 n.61 (stating that "[u]nlike outside directors, the obligation of inside directors . . . is only to their corporation").

95. *See* W. KNEPPER, *supra* note 3, § 1.09 (noting that the higher standard of conduct for inside directors "reflect[s] their . . . greater familiarity with the affairs of the corporation").

96. *See* Soderquist, *supra* note 86, at 1351 (stating that "one thing almost all outside directors have in common is a scarcity of time"); Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1481 (1984) (stating that, on the average, directors devote 1.5 working days per month to board work); Comment, *supra* note 20, at 778 (noting that "[r]estraints on time and information limit severely the amount of impact that outside directors can have upon corporate affairs").

ble as inside directors for mistakes in business judgment.[97]

Because outside directors have limited time to devote to the corporation, they, in particular, can rely on reports and evaluations made by officers, outside professionals, and board committees.[98] As a result of their lack of time to become involved in the details of the corporation's business, outside directors act in more of an advisory capacity,[99] functioning in "a more general decisionmaking and supervisory role."[100]

Views diverge concerning whether different standards of care should be applied to inside and outside directors. At least one court[101] has held that an outside director's due diligence defense of relying on the opinions of officers and auditors is not sufficient to shield the director from liability for a misleading registration statement.[102] Some commentators, however, suggest that given the role of and constraints on outside directors, the only reasonable standard for imposing liability on outside directors is that of "gross negligence or inattention to duty."[103] This attitude is reflected in various court decisions holding that an outside director who has only "limited factual information" is not liable for "breaching his

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97. Soderquist, *supra* note 86, at 1349 (asserting that "it would realistically be very difficult if not impossible to secure the services of able and experienced [outside] corporate directors" if they were required to devote substantial time to the corporation) (quoting Smith v. Brown-Borhek Co., 414 Pa. 325, 333, 200 A.2d 398, 401 (1964)) (emphasis deleted).

98. *See, e.g., Rowen,* 282 N.W.2d at 653 (concluding that outside directors "may within reasonable limits rely on those who have primary responsibility for the corporate business"). W. KNEPPER, *supra* note 3, §§ 1.11-1.14 (discussing the role of outside directors and their reliance on others).

99. *See* Miller, *supra* note 22, at 271 (emphasizing that outside directors provide "advice and counsel on very hroad questions of policy"); *see also supra* notes 89-91 and accompanying text.

100. Soderquist, *supra* note 86, at 1343.

101. Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

102. The *BarChris* court found that two outside directors who relied on reports from officers and a professional auditing firm before signing registration statements soon after their election to the board of directors had not met their burden of proving due diligence. The court reasoned that:

> [An outside director] is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property . . . . [A] prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case.

Id. at 688.

103. Miller, *supra* note 22, at 271; *cf.* Cary & Harris, *supra* note 60, at 64-65 (implying that both a low standard of care for outside directors and a higher standard for inside directors are reasonable).

duty of care when he does not oversee management."[104] One argument for not distinguishing between inside and outside directors is that state statutes generally do not make this differentiation.[105] A persuasive counterargument, however, is that most duty of care statutes impose liability on directors "in a like position under similar circumstances."[106] The nature of their involvement with the corporation places inside and outside directors in different positions and often requires them to act under dissimilar circumstances.

The law governing the duties of directors and officers developed largely from cases concerning bank directors.[107] Some courts held bank directors and officers to a high degree of care.[108] Other courts, however, imposed a less stringent standard.[109] Nevertheless, one commentator believes that bank directors have the duty to exercise a greater degree of care than directors in other industries.[110] In contrast, another commentator has suggested that no difference currently exists between the standards for bank directors and other directors.[111] The decline in the number of cases involving bank directors and officers[112] makes it impossible to predict with

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104. Hahn & Manzoni, *supra* note 44, at 614.

105. *See* Comment, *supra* note 20, at 780 (noting that "the standard of care applicable to directors . . . now codified in a number of state corporation acts, makes no distinction between the functions of inside and outside directors").

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

107. *See, e.g., Briggs*, 141 U.S. at 132; *Percy*, 8 Mart. (n.s.) at 68; *Hun*, 82 N.Y. at 65; Marshal v. Farmers' & Mechanics' Sav. Bank, 85 Va. 676, 8 S.E. 586 (1889); Charitable Corp. v. Sutton, 2 Atk. 400, 26 Eng. Rep. 642 (1742).

108. *See, e.g.*, Prudential Trust Co. v. Brown, 271 Mass. 132, 171 N.E. 42 (1930) (holding that bank directors are liable for losses resulting from ordinary negligence in performing their duties); Greenfield Sav. Bank v. Abercrombie, 211 Mass. 252, 255-56, 97 N.E. 897, 899-900 (1912) (finding that savings bank directors are not excused "for losses due to a mere error of judgment," nor can they "excuse themselves from the consequences of tbeir misconduct or of their . . . negligence by averring that they have failed merely to exercise ordinary skill, care and vigilance"); Barber v. Kolowich, 283 Mich. 97, 104, 277 N.W. 189, 192 (1938) (concluding that rules of conduct for directors and officers "should be applied even more stringently to an officer and director of a bank").

109. *See, e.g., Briggs*, 141 U.S. at 165-66 (holding bank directors to a gross negligence standard); Atherton v. Anderson, 99 F.2d 883, 888 (6th Cir. 1938) (stating that bank directors are assumed to be "honest and faithful but . . . not . . . infallible" and that they must "use ordinary diligence"); Gamble v. Brown, 29 F.2d 366, 370 (4th Cir. 1928) (stating that bank directors are subject to "the common-law duty [of care] . . . which ordinarily prudent men would exercise under similar circumstances"), *cert. denied*, 279 U.S. 839 (1929).

110. *See, e.g.*, Lewis, *supra* note 4, at 163 (commenting that "[i]t is probable that bank cases should be treated differently from non-bank cases with bank directors held to stricter standards").

111. *See, e.g.*, Dyson, *supra* note 13, at 343-44.

112. *See* Bishop, *supra* note 57, at 1098-99 (explaining that bank director cases have

certainty whether a particular jurisdiction will differentiate between bank directors and other directors. The flexible duty of care standard established by most state statutes,[113] however, should result in courts holding bank directors accountable for that degree of care expected of other bank directors in a like position under similar circumstances rather than that expected of directors of corporations in other industries.[114]

V. The Duty of Loyalty

Since at least 1742 courts have required corporate directors and officers to discharge their responsibilities with fidelity to the corporation.[115] This obligation became known as the duty of loyalty.[116] Historically, directors and officers could not engage in conflict of interest transactions without the risk that a court would find their dealings to be voidable at the election of the corporation.[117] A few courts took a more rigid position and held that con-

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become "virtually extinct . . . partly because of the Federal Deposit Insurance Corporation and other New Deal reforms, and partly . . . because the trend toward fewer and larger banks bas made inexperienced and gullible bank directors scarcer than they used to be").

113. The majority of states have adopted the "ordinarily prudent director in a like position under similar circumstances" standard. *See supra* notes 15 & 21 and accompanying text.

114. In addition, courts often state that each case is decided on its particular facts and circumstances. *See supra* note 21. This ensures flexibility and indicates that bank director cases probably will be decided in light of the facts and circumstances as they apply particularly to bank, rather than nonbank, directors.

115. *See Charitable Corp.*, 2 Atk. at 406, 26 Eng. Rep. at 645.

116. *See, e.g.*, Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939). The *Guth* court explained tbe duty of loyalty as follows:

> A public policy, existing through the years . . . . has established a rule that demands of a corporate officer or director . . . the most scrupulous observance of his duty, not only to affirmatively protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated.

Id. at 270, 5 A.2d at 510. The following is another statement of the duty of loyalty:

> It contemplates tbat a director must refrain from engaging in his own personal activities in such a manner as to injure or take advantage of his corporation . . . [D]irectors may not make secret or private profits out of their official positions, and must give to the corporation the benefit of any advantages they obtain in their official positions.

W. Knepper, *supra* note 3, § 1.05.

117. *See, e.g.*, Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 87 (2d Cir. 1955) (holding, under Connecticut law and in the context of a shareholders' derivative suit alleging inadequacy of the price paid for assets of a corporation wholly owned and con-

flict of interest transactions were void.[118] Most jurisdictions eventually adopted a more lenient stance and permitted conflict of interest transactions to stand if they met a test of intrinsic fairness to the corporation[119] and if the directors fully disclosed their interests in the transactions.[120]

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trolled by directors of the buyer corporation, that "where interested directors participate in a transaction and their votes are necessary to consummate it, the transaction is voidable irrespective of its fairness"); Dixmoor Golf Club v. Evans, 325 Ill. 612, 616, 156 N.E. 785, 788 (1927) (finding, in a suit to compel directors to account to shareholders for secret profits they made while acting for the corporation, that if a director does not act "with the utmost fairness . . . [the transaction] will be set aside"); Jacobson v. Brooklyn Lumber Co., 184 N.Y. 152, 162, 76 N.E. 1075, 1078-79 (1906) (stating that actions by individuals who are directors and officers and who vote to increase their salaries are voidable because they are influenced by personal interests).

Mallory v. Mallory Wheeler Co., 61 Conn. 131, 23 A. 708 (1927), explains clearly the rationale for declaring transactions involving a conflict of interest to be voidahle:

> [A]ny one [sic] acting in a fiduciary relation shall not be permitted to make use of that relation to benefit his own personal interest. This rule . . . extends to all transactions where the individual's personal interests may be brought into conflict with his acts in the fiduciary capacity, and it works independently of the question whether there was fraud or whether there was a good intention . . . [t]he underlying thought is that an agent or other fiduciary should not unite his personal and his representative characters in the same transaction; and equity will not permit him to be exposed to the temptation, or be brought into a situation where his own personal interests conflict with the interests of his principal and with the duties he owes to his principal . . . . It is a violation of his duty for any . . . director acting in his fiduciary capacity to enter into any contract with himself connected with the trust or its management. Such a contract is voidable, and may be set aside at the suit of the beneficiary.

Mallory, 61 Conn. at 137-38, 23 A. at 710-11.

118. *See, e.g.*, McKey v. Swenson, 232 Mich. 505, 514, 205 N.W. 583, 586 (1925) (holding that directors' actions were void when they voted on their salaries and then approved the action in their capacity as controlling shareholders of the corporation); Duncan v. Ponton, 102 S.W.2d 517, 519 (Tex. Civ. App. 1937) (finding that a director's assent to an unauthorized exchange of corporate property for obligations owed to the corporation's general manager did not bind the corporation and that the transaction was void); *see also* Comment, *supra* note 20, at 783-84 ("findings of fraud, over-reaching, or waste of corporate assets will confer liability upon the offending director and will result in the voiding of the transaction").

119. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306-07 (1939) (emphasizing that directors have the burden of proving the "inherent fairness" of their dealings with the corporation before an equity court will agree not to set aside a transaction); Pappas v. Moss, 303 F. Supp. 1257, 1276 (D.N.J. 1969) (holding directors and officers liable for engaging in self-dealing transactions because they failed to prove the fairness, honesty, and reasonableness of the transactions); International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576 (Tex. 1963) (iterating that corporate directors and officers must prove that their contracts with the corporation are fair before the court will uphold the arrangements).

120. *See, e.g.*, Raines v. Toney, 228 Ark. 1170, 1181-82, 313 S.W.2d 802, 810 (1958) (holding a corporate director and officer liable for breach of the duty of loyalty after he failed to disclose fully "his diversion of his corporation's property and opportunities"); H.B. Cartwright & Bro. v. United States Bank & Trust Co., 23 N.M. 82, 122, 167 P. 436, 449 (1917) (concluding that a director can engage in transactions with the corporation, but must

Thirty-nine states have codified the duty of loyalty.[121] The statutes vary somewhat, but the majority provide that conflict of interest transactions are not void or voidable if they are fair to the corporation and the director or officer fully disclosed any personal interest in the deal.[122] The Vermont statute, however, appears to leave open the possibility of finding a contract between a director and the corporation to be voidable.[123] Other states apparently rely

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act in good faith and make a "full and fair disclosure . . . to his fellow directors" of all the circumstances); Hansen v. Granite Holding Co., 117 Utah 530, 542, 218 P.2d 274, 280 (1950) (stating that "where the management [of the corporation] is interested in any deal with the corporation . . . then its actions must be open and above board and . . . [i]n such cases courts of equity will carefully scrutinize the dealings of the management and set aside such transactions on slight grounds").

121. *See infra* notes 122-23.

122. *See* ALA. CODE § 10-2A-63 (1980); ARIZ. REV. STAT. ANN. § 10-041 (1977); CAL. CORP. CODE § 310 (West 1977); COLO. REV. STAT. § 7-5-114.5 (1986); CONN. GEN. STAT. ANN. § 33-323 (West 1960 & Supp. 1986); DEL. CODE ANN. tit. 8, § 144 (1983); FLA. STAT. ANN. § 607.124 (West 1977); GA. CODE ANN. § 14-2-155 (1982); IDAHO CODE § 30-1-41 (Supp. 1986); ILL. ANN. STAT. ch. 32, para. 8.60 (Smith-Hurd 1985); IND. CODE ANN. § 23-1-10-6 (Burns 1984); IOWA CODE ANN. § 496A.34 (West Supp. 1986); KAN. STAT. ANN. § 17-6304 (1981); KY. REV. STAT. ANN. § 271A.205 (1981); LA. REV. STAT. ANN. § 12:84 (West 1969); ME. REV. STAT. ANN. tit. 13A, § 717 (West 1981); MD. CORPS. & ASS'NS CODE ANN. § 2-419 (1985); MICH. COMP. LAWS ANN. § 450.1545 (West 1973); MINN. STAT. ANN. § 302A.255 (West 1985); MONT. CODE ANN. § 35-1-413 (1985); NEB. REV. STAT. § 21-2040.01 (1983); NEV. REV. STAT. ANN. § 78.140 (Michie 1986); N.H. REV. STAT. ANN. § 293-A:41 (Supp. 1986); N.J. STAT. ANN. § 14A:6-8 (West Supp. 1986); N.Y. BUS. CORP. LAW § 713 (McKinney 1986); N.C. GEN. STAT. § 55-30(b) (1982); N.D. CENT. CODE § 10-19.9-51 (1985); OHIO REV. CODE ANN. § 1701.60 (Anderson 1985); OKLA. STAT. ANN. tit. 18, § 1030 (West 1986); OR. REV. STAT. § 57.265 (1984); PA. STAT. ANN. tit. 15, § 1409.1 (Purdon Supp. 1986); R.I. GEN. LAWS § 7-1.1-37.1 (1985); S.C. CODE ANN. § 33-13-160 (Law. Co-op. Supp. 1985); TENN. CODE ANN. § 48-1-816 (1984); TEX. BUS. & COM. CODE ANN. art. 2.35-1 (Vernon Supp. 1987); VA. CODE ANN. § 13.1-691 (1985); W. VA. CODE § 31-1-25 (1982); WIS. STAT. ANN. § 180-355 (West Supp. 1986).

Indiana's current law will be repealed effective August 1, 1987. The new law will be IND. CODE ANN. § 23-1-35-2 (Burns Supp. 1986). Similarly, Tennessee's old corporation statute will be replaced by TENN. CODE ANN. § 48-8-302 (Supp. 1986), effective October 1, 1987. The standards remain the same in both states.

Although the language varies from state to state, all state statutes essentially provide that a transaction involving a conflict of interest is not void or voidable because of the director's or officer's interest, or because the director or officer attended a meeting at which the transaction was approved, if the interest or relationship was fully disclosed and the transaction was fair and reasonable to the corporation at the time it was authorized. Authorization by a majority of disinterested board members or ratification by a majority of the shareholders also can prevent the action from being void or voidable.

123. The Vermont statute provides:

> A contract may be made between a corporation and one or more of the directers, if the contract is approved by a quorum of the board of directors, the contracting director not being present. In entering into such contract, the directors shall act in good faith, and, if their good faith is attacked, the burden shall be upon them to prove it. Subject to these provisions, such contract shall be voidable by the corporation only in case it would have been voidable if made with a stranger. The term "contract" as used herein is intended to include loans, and corporation guarantees of personal obligations.

VT. STAT. ANN. tit. 11, § 1888 (1984).

on the common law to limit a director's or officer's ability to engage in conflict of interest transactions.[124]

The duty of loyalty becomes an issue in a variety of situations. Perhaps the most obvious examples of conflict of interest transactions occur when directors and officers engage in self-dealing[125] or usurp a corporate opportunity.[126] Conflicts of interest also can occur when corporations with interlocking directorates enter into agreements with each other.[127] Another potential conflict of inter-

124. The following states have not codified the duty of loyalty: Alaska, Arkansas, Hawaii, Massachusetts, Mississippi, Missouri, South Dakota, Utah, Washington, and Wyoming.

125. *See, e.g.*, Dixmoor Golf Club v. Evans, 325 Ill. 612, 156 N.E. 785 (1927) (holding directors liable to the corporation for the amount of secret profits made from the corporation's purchase of property at an inflated price from a director who held an option on the land); H.B. Cartwright & Bro. v. United States Bank & Trust Co., 23 N.M. 82, 167 P. 436 (1917) (holding that a director or officer who makes secret profits while acting in an official capacity is liable to the corporation for the profits); *cf.* Simpson v. Spellman, 522 S.W.2d 615, 619-20 (Mo. Ct. App. 1975) (maintaining that "a director may conduct personal transactions with his corporation if he can prove that he has not gained unconscionable or secret profits in the transaction and that he has dealt openly, honestly, and fairly with the corporation and the stockholders").

Self-dealing also can occur when a parent corporation, "by virtue of its domination of [its] subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." *Sinclair Oil*, 280 A.2d at 720.

126. *See, e.g.*, *Raines*, 228 Ark. at 1180, 313 S.W.2d at 808-09 (concluding that one who is both a director and an officer has a duty to refrain from engaging in a competing business and depriving the corporation of the director/officer's skills and abilities); *Sequoia Vacuum Sys.*, 229 Cal. App. 2d at 286, 40 Cal. Rptr. at 206 (stating that a director or officer "may not enter into a competing enterprise which cripples or injures . . . [the] corporation of which he remains an officer or director"); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939) (holding a corporate officer liable for usurping a corporate opportunity that should have been offered to the corporation).

The *Corporate Director's Guidebook* advises:

> When an opportunity . . . to acquire another business enterprise, to acquire property, . . . or to seize any other business advantage, comes to the attention of the corporate director as a result of his relation to the corporation in a way that would permit its personal realization, and is relevant to the enterprise's present or prospective business activities, the director must first present it to his corporation. Only after informed evaluation and a determination (by disinterested peers) that the corporation should not pursue such corporate opportunity, should the corporate director pursue the matter for his own account or for the benefit of others.

Guidebook, *supra* note 41, at 1600.

127. *See, e.g.*, Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 418-19, 359 P.2d 665, 668 (1961) (stating that courts will scrutinize carefully a contract between corporations with common directors and find it voidable if it is unfair, and that, regardless of the fairness of the deal, the contract will be voidable if the vote of common directors "is necessary to form a quorum of the board and to effectuate the transaction"); *cf.* Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 280-81, 166 N.E.2d 793, 800 (1960) (holding that "transactions between corporations with common directors may be avoided only *if unfair*," and that the common directors have the burden of proving fairness) (emphasis in original).

est situation exists when loans are made between the corporation and one of its directors or officers.[128] The validity of these transactions depends on the law of the particular jurisdiction.[129]

Courts scrutinize alleged conflict of interest transactions very carefully.[130] The party alleging a breach of the duty of loyalty initially bears the burden of proving the existence of a conflict of interest.[131] Once a conflict is established, however, the burden of proof shifts to the director or officer to show that the transaction was intrinsically fair to the corporation.[132] Most jurisdictions will uphold a transaction involving a conflict of interest if the interested directors or officers fully disclosed their position and if the transaction was approved by a majority of disinterested directors or was ratified by a majority of the stockholders.[133] Other courts will not uphold a transaction, in spite of its fairness to the corporation, unless the interested directors or officers fully disclosed their interest.[134] If the directors or officers meet their burden of proof,

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128. *See, e.g.*, Foster v. Arata, 74 Nev. 143, 153, 325 P.2d 759, 764 (1958) (concluding that loans made by directors and officers to the corporation were not void because they were made openly, fairly, and for the benefit of the corporation); M. FEUER, *supra* note 31, at 59 (explaining that conflicts of interest can occur "when the corporation lends to its directors or officers . . . [but] such transactions will generally be upheld, since they presumptively advance the interests of the corporation").

129. *See supra* notes 117-24 and accompanying text.

130. *See* Comment, *supra* note 20, at 782; *see also* Hansen v. Granite Holding Co., 117 Utah 530, 542, 218 P.2d 274, 280 (1950).

131. *See* Arsht, *supra* note 54, at 116 (stating that "the party challenging the transaction must prove self-dealing or personal interest to make the [business judgment rule] defense inapplicable").

132. *See, e.g.*, Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921) (concluding that in deals involving corporations with common board members, the burden of proving fairness is on the parties seeking to uphold the transactions); Backus v. Finklestein, 23 F.2d 531 (D. Minn. 1924); Popperman v. Rest Haven Cemetery, Inc., 162 Tex. 255, 259, 345 S.W.2d 715, 717 (1961).

133. *See, e.g.*, Rinn v. Asbestos Mfg. Co., 101 F.2d 344, 346 (7th Cir. 1938) (concluding that a transaction of personal interest to some directors of the corporation is not invalid when two-thirds of the board members who approved the contract were disinterested and no evidence demonstrated "bad faith, fraud or ignorance upon the part of the majority" of the board), *cert. denied*, 308 U.S. 555 (1939); Healy v. Geilfuss, 37 Del. Ch. 502, 510, 146 A.2d 5, 10 (1958) (finding that stockholder ratification of acts alleged to be breaches of the duty of loyalty "cures any voidable board action, . . . [unless it] constitutes a gift of corporate assets to [the board members] themselves or is ultra vires, illegal or fraudulent").

Most state statutes provide that a conflict of interest transaction is not automatically void or voidable if interested directors disclose their interest and the action is approved by a majority of disinterested board members or ratified by a majority of the shareholders. *See supra* note 122.

134. *See, e.g.*, Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 87 (2d Cir. 1955) (stating that "where interested directors participate in a transaction and their votes

they are not liable to the corporation or its shareholders.[135] Conversely, if the directors or officers are unable to prove full disclosure or fairness, they may be liable in damages or the court may rescind the transaction.[136] The business judgment rule provides no shelter for directors and officers who breach the duty of loyalty.[137]

Directors and officers may attempt to escape liability by establishing that they had no direct involvement with the corporate decision creating the alleged breach of loyalty.[138] Even if a director does not participate directly in approving the transaction, a breach of the duty of loyalty may occur if the director wields enough power to dominate the other directors.[139] Under these circumstances, if the corporate decision works to the dominant director's advantage, the dominant director may be liable for self-dealing or some other breach of the duty of loyalty.[140]

VI. Conclusion

Regardless of the labels employed, courts have established that corporate directors and officers are fiduciaries to their corporations and its shareholders. Consequently, directors and officers must conform to prescribed standards for the duty of care and the

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are necessary to consummate it, the transaction is voidable irrespective of its fairness" to the corporation).

135. *See, e.g.*, Rinn v. Asbestos Mfg. Co., 101 F.2d 344 (7th Cir. 1938), *cert. denied*, 308 U.S. 555 (1939); Simpson v. Spellman, 522 S.W.2d 615 (Mo. Ct. App. 1975).

136. *See, e.g.*, Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939) (holding that an officer who usurped a corporate opportunity was liable to the corporation for the value of the stock of and the dividends paid by the competing enterprise); Dixmoor Golf Club v. Evans, 325 Ill. 612, 156 N.E. 785 (1927) (declaring that directors who earned secret profits while acting in their corporate capacity were liable to the corporation in the amount of the profits plus interest).

137. *See supra* note 76 and accompanying text.

138. For example, directors and officers may claim lack of direct involvement if they abstained from voting on the transaction at issue.

139. William Knepper, an attorney with Knepper, White, Arter & Hadden in Columbus, Ohio, states as follows:

> Dominating directors are common in closely held corporations and are found occasionally in public corporations. The infiuence and predominance of such a director may effectively control the other directors even though he refrains from voting or absents himself from meetings when votes are taken on matters in which he is personally interested. It is thus the rule that a dominating director cannot support his conflict-of-interest transaction on the ground that the other directors approved the transaction without bis visible participation.

W. Knepper, *supra* note 3, § 2.10.

140. *See, e.g.*, Fowle Memorial Hosp. Co. v. Nicholson, 189 N.C. 44, 49, 126 S.E. 94, 97 (1925) (holding that "a director who exercises a controlling influence over the codirectors cannot defend a purchase by him of corporate property on the ground that his action was approved by them" when the transaction was not made fairly).

duty of loyalty. Although the standards for the duty of care have varied over time and among jurisdictions, they have delineated expectations for the minimum degree of care that a director or officer owes to the corporation. Interestingly, the current standards and expectations are not significantly different from those announced by the early courts. The earliest cases disagreed on whether ordinary or gross negligence was the correct standard of care. This debate continues today. The requirement of loyalty to the corporation remains essentially intact, but the validity of a transaction when a breach of the duty of loyalty occurs has changed appreciably. Just as the early courts sought to define the parameters of directors' and officers' responsibilities and behavior, today's courts engage in the same endeavor.

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