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Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence*

Alan R. Palmiter**

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** Assistant Professor, Wake Forest University School of Law. I thank Professors Lewis Solomon, Charles Koch, Ralph Peeples, Miles Foy, and David Shores for their comments on earlier drafts, but wish to make clear that I alone am swimming upstream. I also thank Stephen Jeffries for his research help.
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It is a fundamental principle of corporate law that directors owe fiduciary duties of care and loyalty to their corporation and its body of shareholders. Under the traditional fiduciary model, directors who are lax in carrying out their functions breach their duty of care, and directors who abuse their positions of trust breach their duty of loyalty. As interpreted over the last century, each duty prescribes a set of standards—a regime—for judicial review of corporate decision making. The care regime, virtually gutted by the famous business judgment rule, mandates judicial abstention in challenges to purely business decisions by directors. The loyalty regime, on the other hand, mandates strict judicial scrutiny of corporate transactions in which directors have conflicting interests. Operating in these two narrow spheres, the fiduciary model makes great sense.

But many of the most significant corporate decisions—for example, setting executive compensation, defending against takeovers, and dismissing shareholder derivative litigation—fall into neither of these two narrow categories. In these matters, the machinery of central corporate governance is uniquely suited to further shareholders’ interests. And yet, management has an inherent conflict of interest that, given the dynamics of board decision making, is likely to be reflected in the board’s decision. Board motives will often be mixed or ambiguous.

About mixed-motive decisions, the accumulated rhetoric of the
traditional care and loyalty regimes has little to say. Existing legal doctrine is inadequate to evaluate these mixed-motive transactions. The care regime would treat any transaction with unique corporate value with near-complete deference. The loyalty regime would subject any transaction implicating conflicting interests to strict scrutiny. The dichotomy has shackled courts and practitioners by leaving no explicit doctrine for dealing with decision making in mixed-motive contexts.

This Article postulates the existence of a conceptually separate duty of independence—a duty of directors to avoid being influenced by colleagues whose interests diverge from those of the corporation and its shareholders. This duty, which is significant primarily in mixed-motive decision making, requires directors to monitor self-interest, a role that neither of the traditional regimes calls on directors to play.

The idea of a duty of independence—and really of a set of intermediate standards of judicial review—is not easy to grasp in the abstract. For purposes of this introduction, consider the well-known, much-dissected case of *Smith v. Van Gorkom*, in which the Delaware Supreme Court imposed potentially multi-million-dollar liability on the eminently credentialed directors of Trans Union Corporation for approving a merger that gave shareholders a fifty percent premium over the market value of their shares. The court held that the directors had breached their duty of care by failing to attend to the merger's details. Commentators and the corporate bar have been astonished.

But *Van Gorkom* was not—as its authors, other courts, the Delaware legislature, and even its critics have assumed—a case about the director's duty of care. Instead, it was one of a growing number of cases implicating a director's duty of independence. The facts of the case included disquieting indications that Trans Union's chief executive officer, Van Gorkom, initiated the merger to cash in his own share holdings in the company before he retired. He may have been more concerned about delivering "his" company to a prominent acquiror than about assuring shareholders the highest price for their shares. The terms of the merger were decidedly one-

1. 488 A.2d 858, 866-69 (Del. 1985).
2. *Id.* at 864.
sided, and attempts to attract higher bids were halfhearted at best.\textsuperscript{5} Cashed-out shareholders sued Van Gorkom and the Trans Union board, claiming that they had breached their fiduciary duties.

The traditional fiduciary model gave the Delaware Supreme Court little to work with. There was no proof of a sufficient self-interest to apply the stringent standards of loyalty review,\textsuperscript{6} and the substantive terms of the merger hardly seemed sufficiently irrational to overcome the business judgment rule's presumption that directors' decisions are reasonable.\textsuperscript{7} But the Delaware Supreme Court agreed that something was not right, or at least that it had to make a statement, and it resorted to the only remaining fiduciary tool at its disposal: the little-used duty of directors to investigate and be informed. It was on this ground that the court held the merger could be invalidated or the directors stuck with paying the difference between what the deal brought and what it should have.

\textit{Van Gorkom} was an independence case in ill-fitting care clothing. Formal recognition of an independence regime would have avoided the confusion of using due care rhetoric to deal with director passivity in a mixed-motive context. In \textit{Van Gorkom} there were substantial reasons both to have doubted the motives of the board and to have been leery of interfering with the unique opportunity for shareholders of a negotiated merger. A duty of independence would have enabled the \textit{Van Gorkom} court to escape the confining care-loyalty dichotomy and explicitly address the case's ambiguity.

There is much to recommend a duty of independence. It would fill the gap left by the dichotomy of the traditional model. Abandoning the care-loyalty dichotomy would focus attention on the board's monitoring role and provide an opportunity for courts, freed from the traditional rhetoric, to develop intermediate standards consistent with the underlying premises of corporate fiduciary regulation: what shareholders expect of their managers and of judicial review (the contractarian premise); what level of judicial review efficiently furthers shareholders' wealth-maximizing interests (the efficiency premise); and how much courts can themselves afford to get involved in reviewing corporate decision making (the prudential premise). It would provide a bridge between academic discourse on these subjects and judicial attempts to set a middle course.

Part I summarizes the general framework of the fiduciary model

\textsuperscript{5} \textit{See id.} at 887-88 ("There is no evidence that the Board gave any consideration to . . . its only legally viable alternative courses of action.").
\textsuperscript{6} \textit{See id.} at 873.
\textsuperscript{7} \textit{See id.} at 870.
and its justifications. I conclude that in the separate, limited contexts in which each regime is intended to operate, the care and loyalty regimes further the contractarian, efficiency, and prudential premises of fiduciary regulation.

Part II explores the traditional model's treatment of directors as independent monitors of management diversion. The traditional care regime applies by its terms to purely business decisions and thus does not purport to apply to directorial monitoring. Yet the lack of an explicit standard of intermediate review has forced courts to contort the traditional care regime in mixed-motive cases. The loyalty regime's evolving attitudes toward the board's monitoring role and the validation function of disinterested directors reflect a general skepticism about the capacity of directors to monitor diversion.

Part III discusses the most pointed mixed-motive corporate decision—how to respond to a takeover attempt—and the variety of adaptive approaches for reviewing such decisions that courts have forged in an attempt to compensate for the limits of the traditional regime. I argue that these adaptations should be viewed as stumbling common-law steps toward an explicit duty of independence and that for the most part, they properly focus on substance, not process.

Part IV presents the justifications for an independence regime and explores the parameters of a director's duty of independence. I argue that a substantive standard requiring mixed-motive decisions to be reasonably related to corporate purposes best furthers the premises of fiduciary regulation. Alternative measures of independence—such as the subjective independence of directors, the structure of the board, or the quality of boardroom deliberations—are flawed and at most marginally useful in achieving the objectives of fiduciary regulation. I conclude with the observation that asymmetric independence review, with different transactional and liability standards, is consistent with traditional loyalty review and the premises of the fiduciary model.

I. The Corporate Fiduciary Model: A Framework

The fiduciary duties directors owe to the corporation and its shareholders—long viewed as consisting solely of the duties of care and loyalty—operate largely as a set of standards for judicial review of corporate decision making.8 These standards have been developed primarily for

8. My principal focus is on fiduciary regulation of corporate decision making. I do not purport to deal with the duty of loyalty implicated when a director deals in a corporation's stock or in its opportunities, except to the extent that such dealings involve corporate decision making. For instance, a board may decide whether a particular corporate opportunity may be taken by an insider.
reviewing decision making in economically large corporations with diffuse ownership and consolidated management control: the modern public corporation. Further, the fiduciary model has historically assumed a board of inside directors, even though the public corporation landscape, since the 1960s, has come to be characterized by boards composed of a significant number, and often a majority, of outside directors. But the model's reticence in embracing the institution of outside directors may not be entirely untoward. Studies of the actual dynamics of modern corporate governance indicate that management—the corporation's senior executive officers—actually operates the business and generally

Cf. Principles of Corporate Governance: Analysis and Recommendations § 5.12(a) (2)(A) (Tent. Draft No. 3 1984) (hereinafter Tent. Draft No. 3) (allowing insiders to take corporate opportunities only after disinterested directors, subject to review under the business judgment rule, have rejected the opportunity); Klinicki v. Lundgren, 298 Or. 662, 681, 695 P.2d 906, 919 (1985) (accepting the approach of the Principles of Corporate Governance: Analysis and Recommendations (ALL Principles)).

9. See, e.g., Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants, 63 CALIF. L. REV. 375, 376-77 (1975) (describing the modern public corporation and the policy-making roles of directors and managers). The fiduciary model applicable to closely held corporations also entails care and loyalty. The close corporation model, however, has developed differently and shows signs that it will further deviate from the generally applicable corporate model. See, e.g., Donahue v. Rodd Electrotype Co., 367 Mass 578, 587, 328 N.E.2d 505, 515-16 (1975) (holding that stockholders in close corporations owe a fiduciary duty to one another like that which partners owe to each other, in contrast to the "somewhat less stringent" duty to which all corporate directors must adhere); Meiselman v. Meiselman, 309 N.C. 279, 288, 307 S.E.2d 551, 568 (1983) (noting that close corporations and public corporations are "functionally quite different"); see also Easterbrook & Fischel, Close Corporations and Agency Costs, 38 STAN. L. REV. 271, 292-93 (1986) (arguing that courts should employ greater scrutiny when reviewing decisions affecting minority shareholders in close corporations); Hetherington & Dooley, Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem, 63 VA. L. REV. 1, 1 (1977) (noting that close corporations may substitute "what amounts to a partnership arrangement for the standard corporate management structure"); Peeples, The Use and Misuse of the Business Judgment Rule in the Close Corporation, 60 NOTRE DAME L. REV. 456, 469-80 (1985) (discussing dividends and shareholder employment in close corporations). Less separation of ownership and control suggests greater deference to management initiatives; yet the captivity of shareholders who generally have fewer market options also suggests a rule of greater scrutiny.

10. By "inside" directors, I mean management directors—that is, directors who are also employed as senior executive officers to direct the operations of the business. See Campbell v. Loew's, Inc., 36 Del Ch. 563, 581-82, 134 A.2d 852, 862-63 (1957). By "outside" directors I mean all other directors, including those who are affiliated with the company (such as auditors, lenders, suppliers, customers, retained attorneys, and investment bankers), as well as those whose only financial affiliation is their directors' fees. Some courts and commentators, perhaps confusingly, have referred to directors in this broad group as "independent." See, e.g., Borowski, Corporate Accountability: The Role of the Independent Director, 9 J. CORP. L. 455, 459-60 (1984) (labeling nonaffiliated directors as "independent"); Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 HARV. L. REV. 597, 598 (1982) (using "outside" and "independent" synonymously); Haft, Business Decisions By the New Board: Behavioral Science and Corporate Law, 80 MICH. L. REV. 1, 1 (1981) (describing nonmanagement directors as "independent").

11. See Haft, supra note 10, at 1 n.4; see also 2 N.Y.S.E. Guide (CCH) ¶ 2495H, at 4229 (Feb. 1988) (stating New York Stock Exchange rule requiring that listed companies have an audit committee and at least two outside directors on the board).

12. The seminal work in this area, by Professors Berle and Means in 1932, set the tone of academic discussion for the next 50 years—management controls the modern public corporation. See A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119 (1932);
controls the information, advice, and alternatives available to the board.13 The public corporation's board serves largely as a "rubber stamp" for management initiatives, and fiduciary regulation of corporate decision making is in a real sense regulation of management.

A. The Fiduciary Model's Dichotomy: The Loyalty and Care Regimes

To say that directors are bound by duties of care and loyalty is to state at once too much and too little. Although "care" and "loyalty" each highlight an aspect of a decision called into question, neither a showing of care nor of loyalty, in a factual or abstract sense, resolves the issue. Instead, through two different regimes of judicial review, the traditional model addresses management slackness and diversion.14 The regimes apply to contexts that lie at the extremes of a continuum. The care regime applies to "enterprise" business decisions and assumes that no conflicting interests are present. The loyalty regime applies when conflicting interests presumably or demonstrably dominated a corporate decision. Neither regime accounts for the possibility of mixed or ambiguous motives on the part of corporate decision makers, and the model thus loses much of its relevance to modern corporate decision making.

1. The Care Regime: Judicial Abstention and the Business Judgment Rule.—Courts review management slackness under the care regime, which applies to enterprise ("purely business") decisions untainted by conflicting interests. Filtered by the forgiving presumptions of the business judgment rule, review applies only in egregious cases of delibera-
tive inattention or irrational decision making. In the care regime, plaintiffs must show more than carelessness or unreasonableness. Judicial abstention is the rule.

Remarkably, the articulated standards of care review—its rhetoric—only vaguely reflect this attitude of abstention. Existing judicial and statutory formulations are widely accepted and vary in their effect only slightly (if at all). They require a director in performing his functions to act in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the skill, diligence, and care of a reasonably prudent person. Both the process and the substance of board decision making are, according to these formulations, subject to scrutiny. The standards, by their terms, seem to regulate the gamut of managerial laxity and poor judgment and sweep broadly to heap liability on any who participate in a flawed decision. With their familiar ring, the

15. "A wide array of duty of care formulations have been propounded by courts and legislatures. . . . It is believed that in most states, in a given case, the same legal result would be reached under each of these formulations." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) comment a, at 14 (Tent. Draft No. 4 1985) [hereinafter Tent. Draft No. 4].

16. The ALI Principles views directors as having both a decision-making and an oversight function. Tent. Draft No. 4, supra note 15, § 4.01(a)(1); see also American Bar Ass'n, Section of Corp., Banking and Business Law, Comm. on Corporate Laws, Corporate Director's Guidebook, 33 BUS. LAW. 1591, 1600 (1978) [hereinafter Corporate Director's Guidebook] (defining a director's functions as "monitoring and directing the activities of corporate management"); Eisenberg, supra note 9, at 396 (defining a board's function as monitoring); cf. Brudney, supra note 10, at 632 n.90 (asserting that courts have not distinguished between the duty to manage and the duty to monitor).

17. Courts have defined the good faith requirement in a variety of ways. Some merely restate one or more of the care regime's standards. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (defining good faith as requiring a showing of a rational business purpose, restating the substantive care standard); Allau v. Consolidated Oil Co., 16 Del. Ch. 318, 325, 147 A. 257, 261 (1929) (defining good faith as prohibiting "reckless indifference to or a deliberate disregard" of corporate interests, thus restating the care regime's substantive and procedural standards). Some courts impose an anticircumvention standard that prohibits inequitable conduct even though it may be legally permissible. See Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971); Lerman v. Diagnostic Data, 421 A.2d 906, 913-14 (Del. Ch. 1980); see also Tent. Draft No. 4, supra note 15, § 4.01(a) comment d, at 21-22, § 4.01(c) comment d, at 64 (containing prohibitions against condoning illegality); S. ARSHT & W. STAPLETON, ANALYSIS OF THE 1967 DELAWARE CORPORATION LAW 327 (1967) (suggesting that a requirement of good faith on the part of outside directors was added to Delaware law to remedy the situation where "literal compliance" with director approval requirements existed, but "some subterfuge . . . or other impropriety" was evident); Hinsey, Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality, 52 GEO. WASH. L. REV. 609, 610 (1984) (characterizing the business judgment rule as an equitable concept, applied when the court finds no self-dealing on the part of the board, provided the directors act with a reasonable measure of diligence and an appropriate measure of good faith).

standards certainly sound in negligence and tort.\textsuperscript{19}

But the rhetoric is deceptive, perhaps purposely so. During their century-long tenure, these standards have produced remarkably few cases holding directors liable for unreasonable or careless decisions. Twenty years ago, Professor Bishop concluded 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.”\textsuperscript{20} This observation remains largely valid today,\textsuperscript{21} and it has come to be true for financial as well as industrial corporations.\textsuperscript{22} Many have noted the gap between the “idealistic” and “realistic” views of directorial behavior.\textsuperscript{23}


21. Professor Bishop counted four cases uncomplicated by self-dealing in which directors were found liable. See id. at 1095-99. The ALI reporters, looking at 100 years of cases, counted six and noted that Professor Bishop had “correctly concluded” that none of those he found carried real conviction. See Tent. Draft No. 4, supra note 15, § 4.01 reporter’s note 17, at 42; see also In re Beatrice Cos. Litr., Civ. No. 86-8248 (Del. Ch. Apr. 16, 1986) (WESTLAW, De-cs database) (finding it “very rare” that disinterested directors breach their duty of care).

22. Before federal bank deposit insurance, early courts articulated and seemed to apply a higher standard of care for directors of banks (and other financial institutions), ostensibly on the theory that overseeing money demands greater prudence than overseeing industry, but more likely in the belief that higher standards were needed to protect uninsured depositors in failed banks. See Briggs v. Spaulding, 141 U.S. 132, 147-48 (1891); Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940); 3A W. FLETCHER, supra note 19, § 1035; Bishop, supra note 20, at 1095-98. These differences, to the extent they existed, have been rejected as “unjustified and anachronistic today.” Tent. Draft No. 4, supra note 15, § 4.01 reporter’s note 18, at 43; Tent. Draft No. 3, supra note 8, introductory note c, at 5; see also McDonnell v. American Leduc Petroleums, 491 F.2d 380, 383 (2d Cir. 1974) (rejecting the proposition that bank directors must conform to a higher standard of care than other corporate directors); Atherton v. Anderson, 99 F.2d 883, 887 (6th Cir. 1938) (holding bank directors to negligence standard); Neese v. Brown, 218 Texm. 686, 691-93, 405 S.W.2d 577, 581-83 (1964) (same).

23. See, e.g., N. LATRIN, supra note 19, § 78, at 276 (suggesting that the imperative that directors attend board meetings is “little more than a pious hope”) (quoting L. GOWER, Modern Company Law, 499 (2d ed. 1957)); Conard, A Behavioral Analysis of Director’s Liability for Negli-
The actual contours of the care regime are expressed in the workings of the business judgment rule, a rebuttable presumption that corporate decisions are honest, informed, and rationally undertaken—that is, a presumption that directors (and managers) do not breach their duty of care. The various articulations of the business judgment rule shield board decisions from judicial second-guessing and directors from liability unless a challenger shows that the corporate decision either was tainted by interest (in which case loyalty review applies), was uninformed (the procedural care test), or lacked a rational business purpose (the substantive care test). Courts accord near-complete deference to corporate decisions, 1972 Duke L.J. 895, 897-98 (discussing the components of an “idealistic” and a “realistic” model of directorial behavior); Manning, supra note 13, at 1481-85 (suggesting that the “reality of the boardroom” should guide any “reformulation of the duty of care”); Veasey & Manning, supra note 18, at 930-42 (contrasting the standard of care required by the Model Business Corporation Act with that developed in Delaware caselaw). The articulated care standards certainly do not begin to intimate the “minimal restraints” and the “wide, and in many respects unpoliceable,... discretion” afforded corporate management. Brudney, supra note 14, at 1410 n.19, 1415.

24. See Tent. Draft No. 4, supra note 15, § 4.01(c), at 6-7; see also Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (holding that the plaintiff had “not overcome the presumption that the ... board properly and prudently exercised its managerial discretion”); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (“It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (“A board of directors enjoys a presumption of sound business judgment.”); Gimbel v. Signal Cos., 316 A.2d 599, 609 (Del. Ch.) (observing that “the sale in question must be examined with the presumption in its favor that the directors who negotiated it honestly believed that they were securing terms ... for the corporation’s best interests”), aff’d on other grounds, 316 A.2d 619 (Del. 1974); Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944) (“[I]t is presupposed that judgment—reasonable diligence—has in fact been exercised.”). One effect of the presumption is that courts often dismiss care cases before trial. See Dent, supra note 13, at 647 n.136.

25. See, e.g., Tent. Draft No. 4, supra note 15, § 4.01 comment d, at 10 (suggesting that the business judgment rule protects officers from “the risks inherent in hindsight reviews” and avoids the “risk of stifling innovation and venturesome business activity”); Veasey, Seeking a Safe Harbor from Judicial Scrutiny of Directors’ Business Decisions: An Analytical Framework for Litigation Strategy and Counseling Directors, 37 Bus. Law. 1247, 1249 (1982) (asserting that managers must find the “safe harbor of the business judgment rule” or be subject to “searching judicial review”). Some commentators have described the rule insulating decisions from scrutiny as the “business judgment doctrine” and the shield against personal liability as the “business judgment rule.” See Hinsey, supra note 17, at 611-14; Veasey & Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge, 63 Texas L. Rev. 1483, 1487-88 (1985). Courts have tended to lump both concepts together. See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 180 n.10 (Del. 1986) (determining that the business judgment rule covers both liability and scrutiny of decisions).

26. See Tent. Draft No. 4, supra note 15, § 4.01(c). A classic judicial formulation is found in Aronson v. Lewis:

The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors.... It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption. 473 A.2d at 812 (citations omitted); see also Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) (holding that directors enjoy a presumption of good faith unless plaintiff can prove self-dealing, bad faith, or fraud); Shlensky v. Wrigley, 95 Ill. App. 2d 173, 181, 237 N.E.2d 776, 780

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decisions untainted by interest, and some scholars have suggested that the deference is\textsuperscript{27} or should be\textsuperscript{28} absolute. Because of the business judgment rule, the care regime imposes little more than hortatory "industry standards," the breach of which has no normative consequence.\textsuperscript{29}

An essential corollary to this attitude of abstention recognizes management's pervasive influence on a board's decision-making process: directors may (and in practice must) rely on management, as well as outside, advice.\textsuperscript{30} Unless a director could not reasonably believe an advisor to be competent or the director knew or had reason to suspect that reliance on the advisor was unwarranted, reliant directors satisfy both their procedural and substantive care duties.\textsuperscript{31} The booming theme in business judgment rule analysis is deference to management.\textsuperscript{32}


\textsuperscript{28} See Haft, supra note 10, at 50; Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 STAN. L. REV. 927, 932 (1983).

\textsuperscript{29} See Hinsey, supra note 17, at 614-15 (stating that the statutory statement of the duty of care serves "a largely aspirational purpose"). But some have argued that "the number of decided cases does not really tell the whole story," because the duty of care may have relevance in settlements. Cary & Harris, Standards of Conduct Under Common Law, Present Day Statutes and the Model Act, 27 BUS. LAW. 61, 66 (1972); see also Coffee, supra note 27, at 796 (arguing that cases favorable to plaintiffs tend to be settled and that cases favorable to defendants tend to be dismissed before trial). But see Cohn, supra note 27, at 600-01 & n.33 (suggesting that indemnification and liability insurance reduce the effect of settlements on directors).

\textsuperscript{30} See, e.g., Rosenblatt v. Getty Oil Co., 493 A.2d 929, 942-44 (Del. 1985) (approving reliance on outside advice); Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985) (suggesting that directors may legitimately rely on outside advice and information from management); REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984) (stating that a director may rely on the advice of employees, officers, or outside consultants whom the director reasonably believes to be competent); MODEL BUSINESS CORP. ACT § 35 (1979) (same); Tent. Draft No. 4, supra note 15, § 4.02 (same); Tent. Draft No. 3, supra note 8, introductory note a, at 1-2 ("[R]eliance is essential in many corporate contexts and...there are inherent dangers in judging a failure by directors or officers to act or foresee in the stark light of hindsight."); see also Spirt v. Bechtel, 232 F.2d 241, 247 (2d Cir. 1956) (approving reliance on legal opinion); Voege v. Magnavo Co., 439 F. Supp. 935, 942 (D. Del. 1977) (finding that an incorrect statement in a proxy was not a misrepresentation because it had been based on legal counsel's advice); Gilbert v. Burnside, 13 A.D.2d 982, 983, 216 N.Y.S.2d 430, 432 (1961) (finding directors not liable for relying on "eminent" but mistaken legal counsel), aff'd, 11 N.Y.2d 960, 183 N.E.2d 325, 229 N.Y.S.2d 10 (1962); Hawes & Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62 VA. L. REV. 1 (1976) (suggesting that reliance on outside legal and professional advice "is germane whenever good faith and due care are defenses to alleged misconduct").

\textsuperscript{31} See REVISED MODEL BUSINESS CORP. ACT § 8.30(c) (1984); MODEL BUSINESS CORP. ACT § 35 (1979); Tent. Draft No. 4, supra note 15, § 4.02 comments g-i, at 82-84.

\textsuperscript{32} Perhaps the only significant open question about the traditional functioning of the business judgment rule is whether it extends to failures to act—that is, to nonfeasance. See Cohn, supra note 27, at 613-15. The prevailing view is that a failure to act must have been conscious to be protected. See, e.g., Gimbel v. Signal Cos., 316 A.2d 599, 609 (Del. Ch.) (stating that the application of the rule
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2. The Loyalty Regime: Judicial Scrutiny of Interested Transactions.—Management diversion is analyzed under the loyalty regime, which applies to corporate decisions motivated by management interests that conflict with those of the corporation. Self-dealing transactions—the loyalty regime's paradigm case of diversion—are regarded with great suspicion, and judicial intervention is the rule in such cases.

The loyalty regime’s premises seem clear enough:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish "depends upon a showing that . . . directors did, in fact, make a business judgment"), aff’d on other grounds, 316 A.2d 619 (Del. 1974); Tent. Draft No. 4, supra note 15, § 4.01(c) comment c, at 60-61 (stating that a good faith decision not to act comes within the "safe harbor provided by the business judgment rule"); Arsht, supra note 19, at 112 (stating that a decision not to act is protected). Unconscious decisions are not protected. See Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) (noting that "[t]echnically speaking, [the business judgment rule] has no role . . . absent a conscious decision"); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (requiring a showing that directors made a decision); Tent. Draft No. 4, supra note 15, § 4.01(c) comment c, at 60-61 (noting that when a failure to act is not the result of a conscious decision, a reasonable care standard applies and the business judgment rule is inapplicable); Block & Prussin, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata, 37 Bus. Law. 27, 33 (1981) (stating that the business judgment rule does not apply when "the director has in fact made no decision").

This view disregards the necessary allocation of board (and management) time. See Tent. Draft No. 3, supra note 8, § 4.01(c) comment b, at 51 ("One of the most important decisions that the board . . . can make is how to allocate its limited time."); Manning, supra note 13, at 1485-86 (arguing that in duty of care analyses, courts should consider that a board's agenda is always infinite and that the number of items not considered always vastly exceeds that of those considered). As a practical matter, distinguishing between failures due to the press of other business and those due to sheer oversight will be difficult. Allocation of board (and management) time, like any other conscious business decision, should be protected by the business judgment rule even if the allocation may not have been entirely prudent. See id. Some courts have accepted the argument that a failure to act is effectively a corporate decision. See First Nat'l Bank v. Cities Serv. Co., 391 U.S. 253, 277 (1968) (stating that a failure to deal, if resulting from nonconspiratorial motives, would be protected by the business judgment rule); Miller v. Am. Tel. & Tel. Co., 507 F.2d 759, 762 (3d Cir. 1974) (stating that "failure to pursue corporate claim" would be protected by the business judgment rule). Further, action on one matter effectively allocates time away from other, presumably less pressing matters. See Graham v. Allis-Chalmers Mfg. Co., 41 Del Ch. 78, 85, 188 A.2d 125, 130 (Del. 1963) (exonerating directors for their failure to "ferret out wrongdoing" by employees because the size and scope of the corporation's activities "required them to confine their control to the broad policy decisions"). Little is served by inquiring into whether such an allocation was conscious or not. The principal reasons for the business judgment rule—insulating management prerogative from judicial meddling and well-meaning directors from liability—support this expansive understanding.

33. The loyalty principles, besides applying to senior executives and directors, also apply to controlling shareholders. See Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-21 (Del. 1971); R. CLARK, CORPORATE LAW § 18.4, at 798-99 (1986).

34. Although the loyalty regime deals broadly with all forms of diversion, including diversion of corporate opportunities and of corporate information by means of insider trading, I limit my discussion to the regime's paradigm coverage: the diversion of tangible assets.

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loyalty to the corporation demands that there shall be no conflict between duty and self-interest.\(^3\)

This mandate of selflessness at first led to rules flatly prohibiting self-dealing.\(^3\) Over time, however, self-dealing transactions have become subject to variously formulated fairness tests concerned with the merits of the transaction and, to an extent, the procedures surrounding its approval.\(^3\) Significantly, throughout the loyalty regime's history, the interested person's subjective integrity or honor has always been irrelevant. Instead, the interested person fulfills the duty of loyalty by showing that the challenged transaction was consistent with corporate interests. Although judicial measures of consistency are continuing to evolve, an interested person generally establishes consistency by showing either the transaction's substantive fairness to the corporation (the prevailing standard)\(^3\) or some combination of fairness and procedurally sufficient validation\(^3\) by disinterested\(^4\) directors or shareholders.\(^4\)

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35. Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939) (applying the corporate opportunity doctrine); see Corporate Director's Guidebook, supra note 16, at 1599-1600 (stating that the duty of loyalty arises when director uses "his corporate position to make a personal profit or gain other personal advantage").

36. See infra text accompanying notes 189-90.

37. See infra subparts II(A)-(B).

38. See infra section II(B)(2).


40. As the cases and the ALI Principles use the term, "disinterested" directors or shareholders are those who are not sufficiently interested in the transaction to trigger loyalty review. See Tent. Draft No. 5, supra note 39, §§ 1.10, 1.18. For example, in a transaction in which management is interested, disinterested directors would include all the outside directors, whether or not they are affiliated with the corporation in some other way, as long as they are not dominated by management.

41. See infra subpart II(B)(3). I do not deal with the question of shareholder validation, which, though widely assumed to insulate self-dealing from searching scrutiny, has received less attention from the courts and the commentators. Generally, courts have shown deference to shareholder validation. Some courts have intimated that shareholders can ratify a fully disclosed transaction even though the court would consider it unfair. See Rivoli Theatre Co. v. Allison, 396 Pa. 343, 351-53, 152 A.2d 449, 453-55 (1959) (Musmanno, J., dissenting); Marsh, Are Directors Trustees?, 22 Bus. Law. 35, 49 (1966); see also R. Clark, supra note 33, § 5.1, at 160 (discussing CAL. CORP. CODE § 310 (Deering 1977), which suggests that informed shareholder ratification is immune from judicial fairness review). Under the ALI Principles, shareholder validation would be adequate if the validated transaction "does not constitute a waste of corporate assets." Tent. Draft No. 5, supra note 39, § 5.02(a)(2)(C). This greater deference, based on the theory that shareholders can decide to squander their own property, assumes that shareholders will vote knowledgeably. This assumption is questionable in public corporations, in which management sets the agenda and controls the proxy machinery. See A. Berle & G. Means, supra note 12, at 81-82 (asserting that management control
these approaches, fairness has two aspects: the self-dealing transaction must replicate a hypothetical “arm’s length” market transaction by falling into a range of reasonableness and must have been of particular value to the corporation as judged by the scope of the corporation's business.42

While care review is squelched by the business judgment rule, loyalty review is side-stepped by rules on what constitutes a tainting interest. Loyalty review applies only when conflicting interests presumptively motivated a decision or when interested persons dominated or controlled the decision-making process.

The paradigm case in which tainted motives are presumed is classic self-dealing in which a manager (or a director or controlling shareholder) engages in a nonunique asset transaction with the corporation. Given that the corporation can engage in a fungible transaction with an outsider, few (if any) countervailing considerations justify less than the fullest scrutiny. Courts assume that diversion motivated the transaction, justifying a review for fairness.43 Fairness is a high standard, and the outcome of a case often turns on the threshold question of whether the challenged decision is treated as interested.44 But classic self-dealing is largely an anachronism in the modern public corporation. Directors and managers rarely sell or buy nonunique assets to or from the corporation.45 In practice, therefore, the presumption of tainted motives arises in the modern public corporation in a relatively narrow range of transactions—namely, transactions between parent corporations and partially

reduces proxy voting to a “rubber stamp [for] the selection already made by those in control”). But cf. Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 406 (1983) (suggesting that if voting were useless it would have been discontinued).

42. See infra notes 219-21 and accompanying text. Other courts have shifted the burden of showing unfairness to the challenging party. See, e.g., Eliasberg v. Standard Oil Co., 23 N.J. Super 431, 440, 92 A.2d 862, 866-67 (Ch. Div. 1952) (shifting the burden to challengers to prove unfairness of a stock option plan for management), aff'd, 12 N.J. 467, 97 A.2d 437 (1953). Still others have required that the interested director merely show that the board exercised honest business judgment. See, e.g., Alcott v. Hyman, 42 Del. Ch. 233, 242, 208 A.2d 501, 507 (Del. 1965) (noting that if stockholders ratify a decision, directors must show only that it came “within the realm . . . of sound business judgment”).

43. See Tent. Draft No. 5, supra note 39, §§ 5.02, 5.07.

44. The presumption can also arise if a director or manager advances the interests of family members, business associates, or a particular group of shareholders. See Tent. Draft No. 5, supra note 39, § 5.08 (requiring loyalty review if a director advances a family member’s or business associate’s pecuniary interest). But see Fogelst in v. Rice, 480 A.2d 619, 624 (Del. 1984) (not requiring loyalty review if benefit is one that flows to all shareholders); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (same).

45. Recent self-dealing cases tend to involve closely held corporations or those with a dominant shareholder. See, e.g., Flieger v. Lawrence, 361 A.2d 218, 221-24 (Del. 1976) (upholding a corporation’s purchase of a close corporation owned by the acquiring corporation’s directors and majority shareholders); Puma v. Marriott, 283 A.2d 693, 695-96 (Del. Ch. 1971) (upholding corporate purchase of six companies from family owning 44% of corporation’s stock); Gries Sports Enters. v. Cleveland Browns Football Co., 26 Ohio St. 3d 15, 23-24, 496 N.E.2d 959, 966 (1986) (assessing liability for self-dealing by 53% shareholder).
owned subsidiaries (such as squeeze-out mergers), loans to executives, and the furnishing of services by affiliated directors and their investment advisors, banks, and law firms.46

Not all instances in which management stands on both sides of a corporate transaction trigger loyalty review. Even when management has a conflicting interest in a transaction, a board’s motives can be seen as mixed or ambiguous if the transaction also offers special or unique value to the corporation because it is not available on the open market. Executive compensation,47 transactions between corporations with interlocking directorates,48 dismissal of derivative litigation,49 and corporate actions taken in the control context (such as takeover defenses)50 are examples of these transactions. In these cases, courts do not assume self-interested influence, and full-fledged loyalty review normally does not apply. Only if self-interest is proved—that is, only if a challenger shows that the interested person dominated or controlled the decision-making process—do courts undertake a loyalty review.51 And failing to prove influence in such mixed-motive contexts casts judicial review, according to the dichotomous fiduciary model, to the forgiving care regime.

3. The Limits of the Traditional Model’s Dichotomy.—Given the disparity in review between the care and loyalty regimes, the outcome of a case often turns on the characterization of the challenge: enterprise (“pure business”) or self-dealing.52 Mixed-motive cases are often effec-

46. See Tent. Draft No. 5, supra note 39, § 5.02 comment c, at 28; see also Western Pac. R.R. Corp. v. Western Pac. R.R. Co., 197 F.2d 994, 1000 (9th Cir. 1952) (asserting that a court must scrutinize the dealings of a parent and a subsidiary managed by the same directors for overreaching, which raises a presumption of constructive fraud).


50. See Marsh, supra note 41, at 60-63.

51. See Tent. Draft No. 5, supra note 39, § 5.03 (not requiring further review of executive compensation if approved by disinterested directors whose decision is not controlled by an interested executive); id. § 5.07 (allowing transactions between corporations with interlocking directorates unless an interlocking director negotiated the transaction or cast the decisive vote); see also Kaplan v. Centex Corp., 284 A.2d 119, 122-23 (Del. Ch. 1971) (noting that a director’s stock ownership alone is not sufficient proof of domination to require loyalty review); Johnston v. Greene, 35 Del. Ch. 479, 485-86, 121 A.2d 919, 922-23 (1956) (applying loyalty review when the court found that an interested director dominated the other directors); cf. Aronson, 473 A.2d at 816 (requiring derivative suit plaintiff to plead “the domination and control of one or more directors” in order to have demand excused).

52. “Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.” AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986). Compare Grobow v. Perot,
tively decided when a court chooses the standard of review.

Although the failure of the dichotomous model to address intermediate contexts is perhaps its most glaring deficiency, another unfortunate (and curious) consequence of this dichotomy is that the model, as applied to large public corporations, has become largely irrelevant. Care review rarely (if ever) will reveal that management or a reliant board was irrational or grossly uninformed. And loyalty review rarely applies because the management of the modern public corporation seldom engages in classic self-dealing and because a showing that self-interest dominated a transaction is difficult to make. The model, to be relevant, begs to be filled out. To do this it is helpful to understand the rationale for fiduciary regulation.

B. Explanation of the Fiduciary Model: Shareholder Wealth Maximization

The fiduciary model derives largely from the separation of ownership and control that characterizes the modern public corporation. This separation, arising from a governance structure in which investor-owners delegate corporate operations to management, creates inevitable “agency costs.” This structure, while generally producing significant efficiencies, creates the possibility that management interests in a variety of contexts will diverge from and conflict with those of the investor-owners. The risk of managerial shirking and diversion is the price of operating through manager “agents.”

The legal restraints of the fiduciary model seek to maximize share-

539 A.2d 180, 189 (Del. 1988) (upholding a corporation’s stock repurchase from a nettlesome director under the business judgment rule) with Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (invalidating a cash-out of minority shareholders in a merger with the controlling shareholder under the entire fairness standard).

53. See supra notes 47-51 and accompanying text.

54. See A. BERLE & G. MEANS, supra note 12, at 119-25. Recent revisionists argue that the gap is overstated, and that market constraints on management make regulation unnecessary in certain areas of apparent conflict. See, e.g., Fischel, The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law, 76 NW. U.L. REV. 913, 917-19 (1982) (pointing out the incentives that managers have to maximize the market value of their services and the value of stock in their option plans and to minimize agency costs to avoid becoming takeover targets); Stigler & Friedland, The Literature of Economics: The Case of Berle and Means, 26 J.L. & ECON. 237, 247-48 (1983) (“The stock may be acquired by a small group by stock purchase if the shares become an attractive speculation, so in an ultimate sense ownership and control cannot be separated.”).

55. See, e.g., Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 UCLA L. REV. 738, 776 (1978) (arguing that centralized management is “highly efficient and greatly enhances the productivity of the shareholders’ capital”).

holder wealth by reducing agency costs. But these constraints do not operate in a vacuum. Agency costs are subject to three principal controls—internal governance constraints, market forces, and fiduciary regulation. Each control complements (and in some instances supplants) the others as constraints on agency costs. On the one hand, internal governance structures and market forces serve as adequate constraints on managerial shirking; therefore, except in the rarest cases, costly judicial interference with decisions about enterprise issues is unwarranted. On the other hand, only strict, normative standards meaningfully constrain diversion; judicial review of decisions motivated purely by conflicting managerial interest is thus worth its cost.

I next discuss in more detail the three controls on agency costs and the three premises underlying fiduciary regulation.

1. **Internal Governance Constraints.**—One way for owner-investors themselves to narrow the gap between ownership and control is by imposing internal governance structures that reduce the opportunities for managerial slackness or diversion. One such structure is inherent in the corporate governance model: shareholders annually elect directors to the board. Although shareholders in public corporations are rarely fickle—a reality that has been widely explored—their coercive vitality as a limit on management slackness and diversion cannot be dismissed.

In addition, owners can take on management functions themselves,
or they can create incentives for management to behave consistently with owners’ wealth maximization interests. For example, executive compensation packages that peg compensation to some measure of shareholder wealth serve to narrow the shareholder-management gap, and their adoption (mostly at management behest) has become an ingrained aspect of the public corporation landscape.60

But in the public corporation, other opportunities to narrow the gap are somewhat limited. Owner management (though characteristic of close corporations) is generally unfeasible61 and legally questionable.62 Owner supervision through outside directors or codes of management behavior is problematic at best.63 And governance structures that limit the temptation of diversion may in some contexts be too costly or practically impossible. For example, it may often be nearly impossible to detect insider trading,64 and fashioning management incentives (such as golden parachute contracts) that sufficiently dissuade entrenchment strategies may be prohibitively expensive.

2. Market Constraints.—Markets for a corporation’s products, for its stock, for corporate control, and for managerial talent interact to narrow the divergence of the interests of owners and managers. The neo-classic argument proceeds as follows: if management misuses corporate resources—whether through ineptitude or laziness or by diverting assets to itself—competition in the firm’s product markets will cause the firm’s profitability to fall. If disclosed, this drop in profits will lead to a relative decline in the price of the corporation’s stock, igniting the ire of current

edge that the claims could be aggregated and votes exercised at any time, tends to cause managers to act in shareholders’ interest in order to advance their own careers and to avoid being ousted.”). 60. See R. Posner, ECONOMIC ANALYSIS OF LAW § 14.6, at 384 (3d ed. 1986); More Managers Find Salary, Bonus Are Tied Directly to Performance, Wall St. J., Feb. 28, 1986, at 27, col. 5.
61. Management by dispersed shareholders is inefficient and creates an obvious “free rider” problem. In a group of widely dispersed investors, only a handful will be likely to have the inclination or the means to learn the business. Others, the vast majority, will be likely to attempt to exploit the efforts of the few. See R. Clark, supra note 33, § 3.1, at 94 & n.9. Those who actively manage the business will find their investment more expensive than that of the free-riding majority and will either withdraw or extract special compensation, eventually becoming indistinguishable from non-owner managers. 62. Corporate statutes authorize the board of directors, not shareholders, to exercise corporate powers. See REvised Model Business Corp. Act § 8.01(b) (1984).
63. Proposals for boards of outside directors often glibly disregard the dynamics of the directorial selection process. If, as seems true, management effectively controls this process, management (not shareholders) will choose the very outside directors who would serve as watchful owner representatives. See Brudney, supra note 10, at 610 n.39.

“The diffuse character of their investments puts shareholders at an enormous disadvantage in crafting . . . bilateral safeguards . . . .” Williamson, supra note 57, at 1210; see also Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 436 (7th Cir. 1987) (Easterbrook, J.) (recognizing the difficulty of parties, anticipating and negotiating terms of codes of behavior).

owners and, if markets in corporate control are working, making it less expensive to acquire control of the corporation. If the owners decide to change management or if new owners purchase control, the slack or rapacious managers will be fired, assuming a competitive pool of managerial talent from which to replace them. The possibility of this scenario, so the argument goes, is not lost on incumbent management and has a disciplining effect.65

But in many contexts, these market constraints are unavailing or insufficiently compelling alone to control agency costs.66 For example, if product markets are not competitive or if excessive management compensation can be hidden, the markets' disciplining effects will be inadequate. If capital markets do not reflect corporate information efficiently—as the October 19, 1987 stock market "correction"67 may indicate—or if management can impede control changes, market constraints will be diluted. Commentators,68 some relying on empirical data,69 have noted that market forces acting alone are inadequate to police management's activities. This perception lies at the heart of fiduciary regulation. 3. **Fiduciary Regulation.**—Fiduciary regulation picks up where internal governance and market constraints leave off. Although it does not reduce the gap between ownership and control, fiduciary regulation creates incentives for management to minimize the effect of the divergent interests, and provides remedies and penalties if management does not.

This regulation takes many forms, sometimes flatly prohibiting specified conduct, sometimes guaranteeing shareholders special supervisory authority, and sometimes mandating disclosure. As a final safety net, the fiduciary model establishes standards for judicial review of conduct that diverges from shareholder wealth maximization. Corporate enabling statutes impose some of these restrictions, such as a prohibition on

65. See R. Posner, *supra* note 60, § 14.6, at 383 ("Mismanagement is not in the managers' self-interest . . . as it will lead eventually to the bankruptcy of the firm (and of the managers' future employment prospects), as a result of the competition of better managed rivals.").

66. See Eisenberg, *supra* note 9, at 400 (pointing out that market constraints do not always work, because, for example, high transaction costs, antitrust barriers, and defensive tactics lessen the threat of a takeover).


69. Cf. E. Sherman, *Corporate Control, Corporate Power* 100 (1981) (stressing the lack of influence the market has on management decision making).
subsidiaries' voting of their parent corporations' shares and a requirement that shareholders approve such matters as mergers and amendments to articles of incorporation. Federal securities laws, in addition to imposing civil and criminal penalties for insider trading, mandate disclosure. The statutory and common-law duties of care and loyalty fill the gaps when specific fiduciary regulations do not apply.

Fiduciary regulation (like any other regulation) can also impose costs greater than the agency costs it saves. Agency costs already constrained by internal governance structures and market forces may not require further fiduciary regulation, particularly if that regulation (largely enforced through derivative litigation) would create additional costs of its own. Judicial abstention under the care regime is justified to the extent that these constraints operate effectively. Only when they insufficiently constrain agency costs, as when self-dealing occurs, is judicial intervention demanded.

I next consider the three premises—contractarian, efficiency, and prudential—for care and loyalty review.

(a) The contractarian premise.—Each duty of the fiduciary model has been explained as a set of implicit fiduciary clauses built into the traditional contract-like relationship between shareholders and management. Shareholders invest money in the corporation and receive a package of expectations, some explicit in the state enabling statute (voting and inspection rights, for example) and others implicit (non-discriminatory treatment and the power to alienate their shares, for example). The fiduciary duties of management and the rights of shareholders to enforce them are both explicit and implicit. Structuring fiduciary duties under a contractarian premise flows from this question: for what duties and rights would (and did) shareholders rationally contract?

70. See, e.g., N.Y. BUS. CORP. LAW § 612(b) (McKinney 1986); see also Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 262 (2d Cir. 1984) (holding that a subsidiary cannot hold or vote the stock of the controlling parent).
72. See id. § 10.03.
74. See Fischel, supra note 56, at 1264.
The care regime's rule of abstention can be seen to flow from this analysis. The business judgment rule is a natural consequence of the statutory delegation to the board (and hence to management in the public corporation) of the power to manage and supervise the business of the corporation—a fundamental element of the shareholder-management “contract.” Investors who choose a corporate form have entrusted their investment to corporate management rather than to derivative suit plaintiffs or the courts. Further, shareholders naturally assume that managers will take reasonable risks. Imposing liability on managers and directors for the consequences of failed decisions chills risk taking and interferes with these contractarian expectations, especially because managers (unlike shareholders) cannot lessen the costs of risk by diversifying their interests in the firm. In enterprise contexts in which risk taking has value, shareholders expect judicial abstention.

Shareholders are not without a remedy for management slackness. They can, and frequently do, exercise their primary contractual protection—they sell their shares, though at a price reflecting the mismanagement. Public shareholders can also use their vote to express displeasure, though they do so less often. History has borne out that as to enterprise matters, they expect little else.

Shareholders have different expectations about management diversion. They expect that their managers will not steal from them, either through outright embezzlement or through self-serving transactions that offer incommensurate corporate gains. Corporate statutes reflect this special attitude toward transactions in which management has a conflicting interest. When management interest motivates corporate decision making, shareholders expect to have recourse to the courts, because internal governance and market constraints have by definition been inadequate. Neither kicking the scoundrels out at the next election nor hoping that the misappropriating managers’ tarnished reputations will make them unemployable provides much solace or compensation.

75. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953 (Del. 1985); Robinson v. Pittsburgh Oil Ref. Corp., 14 Del. Ch. 193, 199, 126 A. 46, 48 (1924); DEL. CODE ANN. tit. 8, § 141(a) (1983); REVISED MODEL BUSINESS CORP. ACT § 8.01(a) (1984); MODEL BUSINESS CORP. ACT § 35 (1979); see also Dent, supra note 13, at 648 n.139 (citing cases in which “judges justify abstention on the ground that the corporation is to be managed by the board, not the shareholders”).

76. See Tent. Draft No. 4, supra note 15, § 4.01 comment d, at 10 (noting that the purpose of its formulation of the business judgment rule is “to avoid the risk of stifling innovation and venturesome business activity”); see also Veasey & Manning, supra note 18, at 931-33 (discussing the desirability of encouraging risk taking).


(b) The efficiency premise.—Closely related to the contractarian premise (and arguably at the heart of it) is a premise that the rules of abstention and intervention are efficient.\(^7\) That is, under each regime, the standards of judicial review reflect the idea that judicial scrutiny is appropriate—that is, efficient—only when the costs of intervening are predictably less than the costs of abstaining.

In the context of enterprise decision making, judicial abstention reflects the undesirability—or relative inefficiency—of courts' intervening in business matters at the behest of a single or only a few shareholders. Derivative suit plaintiffs and judges, assisted in some instances by juries,\(^8\) are likely to be relatively ill-equipped to evaluate or second-guess the adequacy of business decisions.\(^9\) For a variety of reasons, management (acting through the board) is generally the least costly locus of enterprise decision making. Managers will predictably want to maximize firm wealth, because doing so will assure them continuing power, prestige, and handsome compensation and well augment their value in the market for managerial services.\(^1\) Management's incentives thus are

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79. In addition to attacking inefficiency the fiduciary model may in some instances regulate managerial behavior, whether or not inefficient, on fairness grounds. See Anderson, supra note 55, at 776 & n.111. In general, the goals of efficiency (wealth maximization) and fairness will will overlap. But in the care regime, though notions of efficiency seem to predominate, the regime's rhetoric demands liability for slackness on fairness grounds, even though judicial intervention might not be justifiable on efficiency grounds. See id. at 776 n.111 (assuming liability for lazy management that "values [its] increased leisure more highly than . . . lost profits"). The same phenomenon may occur in the loyalty regime when management fraudulently induces economically efficient self-dealing. Regulation is often justified primarily, if not exclusively, on age-old notions of fairness. See, e.g., id. at 761-62 (arguing that fairness requires limiting management discretion). Nonetheless, fairness arguments may be little more than arguments about broader efficiency. Rules against deception, for example, would generally seem to produce long-run efficiencies by reducing the need for costly internal governance controls and encouraging societal truthfulness. See R. CLARK, supra note 33, § 4.2, at 152-53.

80. See Ross v. Bernhard, 396 U.S. 531, 542 (1970) (holding that a derivative suit plaintiff is entitled to a jury trial with respect to those matters on which the corporation would be so entitled if it had brought suit).

81. "[T]here are inherent dangers in judging a failure by directors or officers to act or foresee in the stark light of hindsight." Tent. Draft No. 4, supra note 15, introductory note, at 2; see AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (noting that courts "decline to evaluate the merits or wisdom of the transaction" in part because of a recognition of "the limited institutional competence of courts to assess business decisions"); Dodge v. Ford Motor Co., 204 Mich. 459, 508, 170 N.W. 668, 684 (1919) ("[T]he ultimate results of the larger business cannot be certainly estimated. The judges are not business experts."); Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) (noting the "prudent recognition" that courts are "ill equipped" to judge business decisions). As Professor Brudney has pointed out, "the more such discretion the task requires, the less meaningful or compelling is the law's mandate." Brudney, supra note 14, at 1441-42.

82. See Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288, 293 (1980); Fischel, supra note 56, at 1263; see also National Loan & Inv. Co. v. Rockland Co., 94 F. 335, 337 (8th Cir. 1899) (noting that inside directors share in the profits of diligent decision making). In fact, a significant managerial equity stake often inspires shareholder confidence. See Fischel, supra note 56, at 1263.
more likely to coincide with general shareholder interests than are the incentives for derivative suit plaintiffs and judges. Management will also generally be more qualified to assess the corporation's business and will have greater access to relevant information than shareholders or judges. To the extent the business incurs losses—avoidable or not—shareholders are relatively better able to bear the risk through portfolio diversification. A rule of abstention effectuates these efficiencies by leaving the risk of loss on shareholders, thus making it easier to recruit and keep qualified managers and directors. Rules that keep courts and derivative suit plaintiffs from interfering in well-meaning enterprise decision making serve to maximize shareholder wealth.

On the other hand, a theory of shareholder wealth maximization demands strict judicial scrutiny of corporate decisions motivated by conflicting management interest. In such contexts, the costs of deferential standards would far outweigh the costs of intervention. Because internal governance and market constraints generally provide insufficient protection against self-dealing, fiduciary regulation is necessary to constrain agency costs. Without fiduciary regulation, managers would have fewer incentives to concentrate on business, and would be expected to concentrate even more on their own aggrandizement. Deferential scrutiny of management diversion would thus jeopardize capital formation. The cost of judicial intervention, though still significant because of the sometimes perverse incentives in derivative suit litigation and the risk of bad judging, is predictably less than the cost of allowing self-dealing to flourish under a deferential standard of review. Judges and juries, though perhaps lacking in business acumen, may be particularly adept at assessing charges of deception, lack of integrity, and misappropriation.

83. Judges are not affected by market incentives to maximize wealth and may seek to implement other values. See Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 COLUM. L. REV. 261, 329 (1981); Veasey, supra note 25, at 1266 n.79 (quoting a letter from then Professor and now Judge Easterbrook stating that judges are not subject to market discipline).

84. See Auerbach, 47 N.Y.2d at 630-31, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926-27.

85. See Barnes v. Andrews, 298 F. 614, 617 (S.D.N.Y. 1924) (L. Hand, J.) ("No men of sense would take the office, if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence."); Smith v. Brown-Borhek Co., 414 Pa. 325, 333, 200 A.2d 398, 401 (1964) (stating that if courts applied tort or trust law negligence standards, it would be "almost impossible to secure the services of able and experienced corporate directors" (emphasis omitted)); see also Tent. Draft No. 4, supra note 15, § 4.01 comment d, at 10 ("In order to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, ... [t]he business judgment rule . . . sharply reduces exposure to liability.").

86. See R. CLARK, supra note 33, § 4.2, at 150-54; R. POSNER, supra note 60, § 14.6-.8, at 382-90; Anderson, supra note 55, at 776 & n.111.

87. Interested directors will not approximate the market. See Fischel, supra note 56, at 1264.

88. See Anderson, supra note 55, at 793.
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It usually is not necessary to understand a business to figure out that someone was stealing from it.

(c) The prudential premise.—Prudent allocation of judicial resources should, and does, guide rules of judicial review. Judicial deference to enterprise decisions seems entirely proper because management prerogatives essentially arise from a private relationship to which shareholders have acceded voluntarily. The need for judicial intervention into corporate relationships is less compelling than the need for intervention into nonconsensual relationships that compels courts, for example, to run prisons or to scrutinize government agency decisions.

In the care regime, in which there is little reason to believe judicial intervention will improve management’s performance, judges have understandably eschewed clogging their dockets with questions of how to run a business. And even if courts were equipped to evaluate business matters more competently than management, the burden on the judiciary of intervening in the far-flung minutiae of corporate decision making argues on prudential grounds for lenient standards of review.

From this standpoint, only compelling reasons or particular, non-recurring problems justify judicial intervention. This describes the circumstances of review under the loyalty regime. For most corporations, management diversion—other than through executive compensation—is a nonrecurring discrete event. The fairness of a self-dealing transaction, besides being of great importance to shareholders, is a neatly packaged corporate issue compared to the broad range of issues implicated in a typical enterprise matter.

4. An Inescapable Conclusion: The Dichotomous Model’s Blindness to a Middle Ground.—While the contractarian, efficiency, and prudential premises readily explain and justify the functioning of the fiduciary model at each extreme, they also imply different rules when directors’ or managers’ motives predictably fall somewhere between advancing enterprise interests and self-interests.

I next explore how the traditional fiduciary model has dealt with regulation of directorial monitoring in contexts tainted by inherent or actual conflicts.

89. See 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) (noting that the “business judgment doctrine ... is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate ... business judgments”).
90. See Siegel, Tender Offer Defensive Tactics: A Proposal for Reform, 36 HASTINGS L.J. 377, 395-96 (suggesting that courts have invoked the business judgment rule to avoid making complex corporate decisions even when fairness dictated that the court should intervene).
II. Monitoring Conflicts Under the Traditional Model: The Role of Independence

An analysis of the traditional fiduciary regime is useful in justifying and structuring a new independence regime. Neither the care regime nor the loyalty regime conceives of the directors as monitors of diversion. The care regime, designed to operate in purely business contexts, assumes that no interested motives exist and that monitoring is therefore unnecessary. Nonetheless, courts have strained to apply the care regime in contexts in which unproved but inferable taint exists. Though the cases sometimes masquerade as care cases, courts have in truth reviewed the substance of these mixed-motive director decisions under more exacting standards. The underlying impetus for these cases, often muddled by the care rhetoric, implicates a wholly different duty—a duty of independence.

The loyalty regime, premised on the need for a searching inquiry of directorial conduct in cases in which interested motives dominate, also does not assume a monitoring role for directors. Indeed, the evolution of the loyalty regime reflects a distrust of directors as monitors of diversion, placing its trust instead in judicial review of the substance—not the process—of interested decisions. Recent proposals to eviscerate judicial review in loyalty cases underscore the need for recognition of an intermediate independence regime.

A. The Care Regime: Retracting Abstention in Tainted Contexts

Corporate reality and management motives are rarely as clear as the fiduciary model assumes. Not surprisingly, review of corporate decisions in the care regime varies according to their context. Review of enterprise decisions untainted by conflicting interests is forgiving and virtually empty. But when decisions are tainted—though not in such a way as to trigger loyalty review—care review becomes meaningful. Courts readily make this adjustment by resorting to the toothy and malleable rhetoric of the care regime's substantive and procedural standards.91

91. I purposefully do not treat a significant group of cases traditionally handled under the care regime—those involving corporate illegality. See Tent. Draft No. 3, supra note 8, introductory note b, at 4-5 (stating that the business judgment rule does not apply to knowing violations of law); Arsht, supra note 19, at 129-30 (stating that the business judgment rule does not apply to decisions that are contrary to law); Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099, 1183 (1977) (explaining that supervision cases are more common than illegal waste cases because of their lower culpability threshold); Small, The Evolving Role of the Director in Corporate Governance, 30 HASTINGS L.J. 1353, 1360 n.35 (1979) (discussing director liability for negligent failure to prevent illegality). These cases do not involve standards of review of management slackness, but rather provide derivative suit enforcement of noncorporate norms (such as labor, antitrust, bribery, and campaign spending laws). See,
I. Safety Valve Liability: Heightened Substantive Review.—The substantive standards of the care regime require that a corporate decision be “reasonably believe[d] to be in the best interests of the corporation.”

Actual substantive review, however, filtered by the forgiving presumptions of the business judgment rule, focuses on whether the challenged decision had a rational business purpose, or rational basis.

Under the substantive rational basis standard, courts defer to corporate decisions in untainted enterprise contexts unless a decision is “imprudent beyond explanation.”

The few cases imposing liability under e.g., Miller v. AT&T, 507 F.2d 759, 764 (3d Cir. 1974) (holding that a violation of campaign contribution laws was not a breach of a fiduciary duty if it based on a legitimate business reason); Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 85, 188 A.2d 125, 130 (1963) (finding that the failure of directors to detect criminal antitrust violations was not a breach of duty since the board had no knowledge or suspicion of it); Abrams v. Allen, 297 N.Y. 52, 55-56, 74 N.E.2d 305, 306-07 (1947) (finding the dismantling of plants to discipline unruly employees actionable); Roth v. Robertson, 64 Misc. 343, 346, 118 N.Y.S. 351, 353 (Sup. Ct. 1909) (finding a managing director liable for paying “hush money” to protect an amusement park's Sunday operations). These are fiduciary cases only in the sense that the plaintiffs sought supplemental, noncorporate enforcement against fiduciaries. They are, in my view, irrelevant to care analysis, and for that matter to corporate fiduciary law. See R. CLARK, supra note 33, § 3.4, at 132-33 (stating that the care regime does not, and should not, compel directors to institute legal compliance programs that are wasteful but may compel systems of internal accounting to detect self-dealing).

92. REVISED MODEL BUSINESS CORP. ACT § 8.30(a)(3) (1984); MODEL BUSINESS CORP. ACT § 35 (1979); see also Meyers v. Moody, 693 F.2d 1196, 1209-11 (5th Cir. 1982) (defining due care as “that degree of care that a person of ordinary prudence would exercise under similar circumstances”); McDonnell v. American Leduc Petroleums, 491 F.2d 380, 383 (2d Cir. 1974) (defining due care as “that degree of care that men of common prudence take of their own concerns”) (quoting National Automobile & Casualty Ins. Co. v. Payne, 261 Cal. App. 2d 403, 413, 67 Cal. Rptr. 784, 790 (1968))); Tent. Draft No. 4, supra note 15, § 4.01 comment d, at 11 (providing for absence of liability if a director “rationally believes” his decision is in the corporation's best interest); Tent. Draft No. 3, supra note 8, § 4.01(d) comment f, at 63 (arguing for greater protection than the reasonableness standard now provides).

93. E.g., Buckhorn, Inc. v. Ropak, 656 F. Supp. 209, 229 (S.D. Ohio 1987); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 244 (D. Neb. 1972). The ALI reporters, while recognizing that some courts have articulated a rational basis test, conclude that “[s]ound public policy dictates that directors and officers be given greater protection than courts and commentators using a 'reasonableness' test would afford.” Tent. Draft No. 3, supra note 8, § 4.01(d) comment f, at 63; see also Tent. Draft No. 4, supra note 15, § 4.01 comment d, at 10-11 (noting that a rational basis test provides protection for decisions 'that might arguably fall outside the term 'reasonable' but are not so removed from the realm of reason when made that liability should be incurred”).

94. Tent. Draft No. 4, supra note 15, § 4.01(e) comment f, at 67-69.

95. Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 572, 224 A.2d 634, 640 (1966); see also id. at 584, 224 A.2d at 646 (“With the knowledge which defendants had of the unsuitability of the Paterson plant for profitable production, the pouring of Manganese's funds into this plant defies explanation . . . .”). Other formulations are all in the same vein. See, e.g., Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978) (holding that the decision must be “so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion”), cert. denied, 439 U.S. 1129 (1979); Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979) (requiring liability if “no person of ordinary sound business judgment” “would consider the challenged transaction ‘fair’” (quoting Kaufman v. Schoenberg, 33 Del. Ch. 211, 223, 91 A.2d 786, 793 (1952))); Warshaw v. Calhoun, 43 Del. Ch. 148, 157-58, 221 A.2d 487, 492-93 (1966) (requiring a “gross abuse of discretion”); Saxe v. Brady, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (1962) (not allowing liability unless “no person of ordinary, sound business judgment” would find the consideration sufficient); Allaun v. Consol. Oil Co., 16 Del. Ch. 318, 325, 147 A. 257, 261 (1929) (requiring “reckless indiffer-
this standard are old and almost without exception involved imprudent banking practices in the era before national bank regulation. The varieties of imprudence the current standard forgives demonstrates its actual toothlessness. Under the business judgment rule, any rational business purpose shields a decision from attack and the directors from liability.

Different considerations and a different standard of review apply to corporate decisions tainted by interest. If it is clear that directors acted from self-interested motives, a loyalty-fairness test applies. But when evidence of interest and motive exists but falls short of proof, a different test has been applied—a more stringent rational basis standard. Although at least one commentator has described this second standard as a surrogate for loyalty analysis, it is far from clear that the courts could or should have imposed the loyalty-fairness standards in these circumstances to or a deliberate disregard of shareholder interests); Spering's Appeal, 71 Pa. 11, 24 (1872) (mandating conduct "so gross as to appear . . . absurd"); see also Tent. Draft No. 4, supra note 15, § 4.01 comment d, at 11 (not providing liability unless a decision is "so removed from the realm of reason when made that liability should be incurred"). See generally Arsh & Hinsey, supra note 19, at 957-61 (discussing cases that employ the rational basis standard). Commentators take a similar view. See, e.g., Caplin, Outside Directors and Their Responsibilities: A Program for the Exercise of Due Care, 1 J. CORP. L. 57, 60 (1975) ("[I]f a decision of a board of directors can be attributed to 'any rational business purpose,' a court will not hold a director liable for honest errors or mistakes of judgment."); Hinsey, supra note 17, at 613-15 (stating that liability requires conduct that "bordered on abdication"); Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. PA. L. REV. 1, 52 (1987) (noting that the presumption of sound business judgment is overcome by evidence of "gross overreaching"); Phillips, supra note 68, at 662-64 (stating that liability usually requires "egregious facts").

96. See, e.g., Hun v. Cary, 82 N.Y. 65, 79 (1880) (holding bank directors liable for their "improvidence" and "reckless, unreasonable extravagance" in buying land and erecting a new bank building under a $30,500 mortgage when the bank faced a $57,000 deficit); see also Bishop, supra note 20, at 1095-97 (suggesting that bank cases predominated in this area because of the "particular solicitude" afforded depositors before the advent of the Federal Deposit Insurance Corporation).

97. Many examples of this jurisprudence exist. In Kamin v. American Express Co., 86 Misc. 2d 809, 814-15, 383 N.Y.S.2d 807, 811 (Sup. Ct.), aff'd on opinion below, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1976), the directors faced a choice of liquidating a bad stock investment at the corporate level or distributing the stock to shareholders as a special dividend, a distribution that would have required shareholders to pay additional taxes totalling $8 million. The choice seemed obvious, or at the least compelling—directors are, after all, fiduciaries of the shareholders. Nonetheless, the board opted for the stock dividend, despite shareholder protests, because of a concern that liquidation would have had an "adverse effect . . . on the net income figures" of the corporation, and the court found that concern sufficient. Id.; see also Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878, 879 (Del. 1970) (upholding an agreement to make payments to the county in lieu of a tax that had been abolished); Sihensky v. Wrigley, 95 Ill. App. 2d 173, 183, 237 N.E.2d 776, 781 (1968) (upholding the majority shareholder's sentimental preference for daytime baseball for the Chicago Cubs despite the claim that night baseball, adopted throughout the league, was more profitable).

98. See Brudney, supra note 10, at 614 n.50 (arguing that very few care cases involve egregious inattention to duties but that most revolve around acquiescence to insiders).


101. See id. at 203-09; Phillips, supra note 68, at 659-64.
cases. The risk of wrongly finding liability for a loyalty breach justifies circumspection. Instead, these are what I call "safety valve" cases—cases in which courts impose liability under a heightened substantive standard because, though deference is not justified, loyalty review is inapposite.

Courts have only occasionally taken this route. In Gimbel v. Signal Cos., the Delaware Court of Chancery preliminarily enjoined a corporation's sale of a wholly owned oil and gas subsidiary to an unaffiliated purchaser and potential corporate raider for an allegedly inadequate price. The court found that the directors may have acted "without the bounds of reason," despite evidence that the sale would allow the company to pay off debts, increase interest income, move capital to more productive subsidiaries, and avoid the risk of oil price controls and excess profits taxes—perfectly credible motivations that would have provided a sufficient business purpose under the rational basis standard.

But more was involved. The court stated that the plaintiff’s case was not sufficient to "pierce" the business judgment rule and hence it did not apply a fairness standard to the terms of the sale, apparently recognizing the need to give the board latitude in selling parts of the business. The court suggested, however, that management may have been using the sale to rid itself of a nettlesome minority shareholder group. Citing the board's "lack of consideration" for minority interests, the court said that the sale "gives rise to the allegation, which probably cannot be established as motivation, that management was trying to effectively freeze out a minority interest." The court did not decide upon which motive—to freeze out the minority interest, to defeat the raider, or to carry out reasonable business purposes—the board had acted. Instead, in a context tainted by interest that "probably cannot be established," the court imposed a higher standard of substantive review of the decision on its merits. It avowedly did not impose fairness review. Gimbel on its face is a safety valve case.

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102. 316 A.2d 599, 618 (Del. Ch.), aff'd on other grounds, 316 A.2d 619 (Del. 1974).
103. See Veasey, supra note 25, at 1253. The purchaser had been interested in acquiring Signal because of its oil assets; its purchase of the subsidiary apparently sated that desire.
104. Gimbel, 316 A.2d at 615.
105. Id. at 612-13.
106. Id.
107. Id. at 614.
108. Another widely mentioned safety valve case is Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634 (1966), a case mistakenly identified by Professor Bishop as imposing care liability for mismanagement uncomplicated by self-dealing. See Bishop, supra note 20, at 1100; Phillips, supra note 100, at 208 n.120. In Selheimer, the Pennsylvania Supreme Court upheld the liability of four managing directors and one nonmanaging director for the loss in value suffered by public shareholders ostensibly due to negligent mismanagement. See Selheimer, 423 Pa. at 585-86, 224
Likewise, in *Litwin v. Allen*, widely cited as involving heightened care standards for bank directors, the court imposed care liability on directors of Guaranty Trust, a bank affiliate of J.P. Morgan & Company, for approving stock repurchase agreements (repos) in the tenuous stock market after the 1929 crash. Guaranty entered into the repos with the holding company for the Van Sweringen empire, in which Morgan was deeply involved and whose sagging fortunes it was clearly interested in buttressing. The plaintiffs, however, did not rest their case on a loyalty theory, and the court explicitly found no evidence of either improper influence or personal interest. Nonetheless, the court held that the "arrangement was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice."

That the directors had failed to attend to the repos' risk seems unlikely; the directors were, as one commentator has pointed out, "among the most experienced risk assessors in the commercial or investment banking communities." Instead, the directors' very sophistication may have justified liability. It seems inconceivable that they were unaware of the significance of the relationship between Morgan and the Van Sweringen companies. The repossession would have met a rational basis test, given the not unattractive five and one-half percent interest they carried. In the face of possible self-dealing by the controlling shareholder, however, they were not sufficiently attractive to justify the usual

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A.2d at 646-47. The shareholders' loss, however, appeared to have stemmed equally from the directors having failed to abide by representations they made to shareholders in connection with the public issue, their having engaged in a "pattern of self-enrichment," and their having violated their duties both in "the unauthorized payment of salaries to themselves" and in the unauthorized purchases of equipment from a firm owned by two of the manager-directors. See id. at 584, 224 A.2d at 646 (quoting the chancellor). The chancellor found no fraud, personal profit, or self-dealing. *Id.* The case, with respect to the managing directors, neatly fits a safety valve analysis.

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110. Under the repos, Guaranty Trust purchased convertible 5 1/2% Missouri Pacific debentures, at $100 par, from Alleghany, the holding company, for cash. Alleghany retained an option to repurchase the debentures at par in six months. *Id.* at 677. In effect, the transaction was a loan, secured by the debentures. *Id.* at 692. If Alleghany repurchased the debentures, Guaranty Trust would have parted with cash for six months and earned 5 1/2% interest in the meantime. If Alleghany did not repurchase, as happened, Guaranty Trust would retain the collateral. *Id.* at 694. The key to the transaction was the solidity of the debentures and Missouri Pacific, both of which turned out to be victims of the depression. *Id.* at 696. The Guaranty Trust board's judgment that the panic had reached the bottom when it approved the repos "proved to be erroneous." *Id.* at 677.
113. *Id.* at 699.
deference, and the board's approval was held to a higher standard of review.

Less cited, but equally relevant to this analysis, is the court's decision in *Litwin* to uphold three other transactions approved by the board, each also tainted by the Van Sweringen connection. The court concluded that each decision reflected "independent judgment" by management and the board.\footnote{115} Presumably applying the same standards it applied to the repossessions the court seemed convinced of the business justifications for these transactions and hence that the Morgan interest had not motivated them. Significantly, the court (purposely, it seems) failed to characterize the decision making surrounding the repossessions approval as independent, while specifically reaching that conclusion about the other decisions. Further, as to each of the sanctioned transactions, the court found comfort in the board's thorough deliberations,\footnote{116} an aspect of the repossessions it did not discuss. In no instance, however, was there any intimation that the court was using an arm's-length, fairness analysis. The care rhetoric provided a convenient safety valve.

In both *Gimbel* and *Litwin*, intervention occurred not because the challenged transactions were without justification but because in each case the decision-making context suggested a self-interested taint. The decisions were therefore subject to a heightened scrutiny on their merits, a scrutiny greater than that applied in untainted enterprise cases but less than that applied in loyalty cases.\footnote{117}

2. Procedural Care Review: Abetting and Mixed-Motive Liability.—A similar distortion of care regime analysis has happened in cases addressing directors' duties of procedural care—cases involving lapses in directorial attention and supervision. In untainted enterprise contexts, notions of causation and the premises of the fiduciary model compel judicial abstention, tracking the rational basis precedent. But when the context suggests that a corporate decision was based on interested motives, review is more searching. Knowing failure to supervise management di-

\footnote{115} The court approved director stock purchases, see *Litwin*, 25 N.Y.S.2d at 691; risky loans to Van Sweringen companies, see *id.* at 726; and a collateral auction of failed Van Sweringen investments, see *id.* at 736. The difference in results might also be understood as a well-crafted settlement, for which the rhetoric of the care regime proved remarkably useful. No appeal was taken from the imposition of individual liability.

\footnote{116} See *id.* at 681, 726, 737.

\footnote{117} Some have suggested that the duty of care is an extension of the duty of loyalty. See, e.g., Phillips, *supra* note 68, at 692. Others have concluded that the loyalty and care analyses are indiscernible from a theoretical standpoint. See, e.g., Scott, *The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71 CORNELL L. REV. 299, 308 (1986). The "safety valve" cases suggest otherwise.
version, unattended by demonstrable personal interest, results in "abetting" liability—the procedural version of the substantive safety valve cases. And when the context suggests that a decision was based on a mixture of enterprise motives and self-interest, heightened "due care" standards serve as a surrogate for intermediate substantive review.

The rhetoric of procedural care, found in statutes adopted in a majority of states, speaks of the care "an ordinarily prudent person in a like position would exercise under similar circumstances" or of the care "a reasonably prudent person would exercise in managing his own personal business affairs." Most courts use similar language. But because the business judgment rule shields directors from the application of this analysis, the actual standard lies in the "informed basis" exception to the rule, which requires a plaintiff to show that a director's decision was uninformed. "Uninformed" has been understood to mean that the directors were grossly negligent or that they engaged in a "sustained


119. The "own affairs" formulation may be more demanding. Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 578, 224 A.2d 634, 643 (1966) (describing the former Pennsylvania "own affairs" standard as requiring "a much higher degree of care" than a "like position" standard). Professor Brudney has pointed out that the "like position" formula focuses on standard boardroom decision-making behavior as defined by the testimony of experts (other directors). See Brudney, supra note 14, at 1441 n.99. This formula therefore seems to raise the threshold of liability. See id. (citing Principles of Corporate Governance and Structure: Restatement and Recommendations § 4.01(a) comment a & reporter's notes, at 151, 164-73 (Tent. Draft No. 1 1982) [hereinafter Tent. Draft No. 1]); see also Cohn, supra note 27, at 626-27 (asserting that the appropriate judicial inquiry is not how other reasonably prudent directors might have reacted, but whether the decision of the defendant directors is supported by a significant portion of the information available to them). Some commentators have urged the higher standard as a way to stem the erosion of the care regime. See Mace, The President and the Board of Directors, Harv. Bus. Rev., Mar.-Apr. 1972, at 37, 48-49; Veasey & Manning, supra note 18, at 961-62. Professor Clark concludes, however, that the "own affairs" formulation probably would not produce results different from the "like position" standard. R. CLARK, supra note 33, § 3.4, at 123.

120. See Tent. Draft No. 4, supra note 15, § 4.01(a) reporter's note 17, at 42 ("[I]n a substantial majority of the decided cases for over one hundred years judges have articulated the culpability standard for dnty of care violations in terms of reasonable care."). Commentators have also articulated a reasonable care standard. See, e.g., Tent. Draft No. 3, supra note 8, § 4.01(a) reporter's note 16, at 39 (citing 3A W. Fletcher, supra note 19, § 234); N. Lattin, supra note 19, § 78, at 274; Dyson, The Director's Liability for Negligence, 40 Ind. L.J. 341, 371 (1965).

121. See Tent. Draft No. 3, supra note 8, § 4.01(d) reporter's note 2, at 70; see also Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that directors have a "duty to inform themselves . . . of all material information reasonably available); Mitchell v. Highland-Western Glass Co., 19 Del Ch. 326, 330, 167 A. 831, 833 (1933) (finding no business judgment rule protection for "an unintelligent or unadvised judgment").

122. Brudney, supra note 14, at 1410 n.19; see Bucyrus-Erie Co. v. General Prod. Corp., 643 F.2d 413, 420 (6th Cir. 1981); Jones v. Foster, 70 F.2d 200, 204 (4th Cir.), cert. denied, 293 U.S. 558 (1934); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Burkhart v. Smith, 161 Md. 398, 403, 157 A. 299, 301 (1931); H. Ballantine, Law of Corporations § 62, at 156-57 (rev. ed. 1946); N. Lattin, supra note 19, § 78, at 274. Although the gross negligence formulation has not yet been widely used, see Tent. Draft No. 4, supra

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pattern of inattention.” These formulations are similar in their effect to the deferential substantive “rational basis” standard.

Of the reported cases imposing care liability in untainted, enterprise contexts, none actually turned on a failure of the process of decision making Courts simply have not held directors liable for failing to notice and supervise untainted mismanagement, no matter how inept the managers. This remarkable absence stems not from the deferential informed basis standard but from the rational basis standard and the rule of causation that courts apply in enterprise contexts. Unless greater attention would have avoided the loss, courts will not upset the transaction or hold the director liable. Learned Hand applied this causation rule in Barnes v. Andrews, a case concerning an accommodation director, a friend of the company president, whose “only attention to the affairs of the company consisted of talks with the president as they met from time to time.” Hand concluded that because a court could not assume that the director could have prevented the business’s failure, he could not be liable.

note 15, § 4.01(a) reporter’s note 15, at 39 (noting, prior to Van Gorkom, that case law in only three states had adopted a gross negligence standard), its use is increasing. See, e.g., Meyers v. Moody, 393 F.2d 1196, 1209 (5th Cir. 1962) (interpreting the Texas business judgment rule not to protect “intentional misconduct or gross negligence”); Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 226 (S.D. Ohio 1987) (recognizing the Delaware gross negligence standard (citing Aronson, 473 A.2d at 812)); Allison v. General Motors Corp., 604 F. Supp. 1106, 1122 (D. Del.), aff’d, 782 F.2d 1026 (3d Cir. 1985) (requiring allegation that a board “through gross negligence failed to reach an informed decision”).


125. 298 F. 614 (S.D.N.Y. 1924).

126. Id. at 615. The ALI Principles makes a similar assumption in its provision on a director’s liability for omission:

An omission that constitutes a breach of [the duty of care] is the legal cause of the loss if the plaintiff proves that (i) the performance of the duty would have been a substantial factor in averting the loss and (ii) the likelihood of injury would have been foreseeable to an ordinarily prudent person in like position to that of the defendant and under similar circumstances.

PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.16(b), at 223-24 (Tent. Draft No. 8 1988) [hereinafter Tent. Draft No. 8].

127. Id. at 618. In untainted contexts, a requirement of proximate cause is well established. See Briggs v. Spaulding, 141 U.S. 132, 151 (1891); Hoehn v. Crews, 144 F.2d 665, 673 (10th Cir. 1944), aff’d, 324 U.S. 200 (1945); Michelsen v. Penney, 135 F.2d 409, 419 (2d Cir. 1943); Wallach v. Billings, 277 Ill. 218, 232, 115 N.E. 382, 387 (1917); Allied Freightways v. Cholfin, 325 Mass. 630,
In untainted contexts, this causal assumption is justified. Imposing liability for inattention to mismanagement that itself would be protected by the business judgment rule would undermine the premises upon which care abstention is founded. As Learned Hand pointed out, "[W]hen a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful, or how much in dollars he could have saved?" Either inquiry would be inconsistent with the contractarian, efficiency, and prudential justifications for abstention in untainted enterprise decision making. Shareholders, concerned with the effect of board decisions on the value of their investment, are indifferent to how a decision is reached so long as it passes substantive scrutiny. To impose greater scrutiny on directorial failures to control mismanagement would undermine shareholders' expectations of management discretion. When in an untainted enterprise context a board's decision is rational, to allow a derivative plaintiff to mire a court in reviewing and conjecturing about boardroom procedures either would create the precise risks of judicial second-guessing that the business judgment rule seeks to avoid or (as bad) would foster the introduction of rigid rules of corporate due process. The long and complete antipathy of courts toward procedural liability is telling.

But procedural cases complicated by interested motives offer much more fertile ground for liability. Cases of inattention to management conflicts fall into two categories: inattention to palpable self-dealing (the


Other cases have applied the same causation analysis in tainted contexts. See, e.g., Warner v. Penoyer, 91 F. 587, 591 (2d Cir. 1898) (holding absentee directors not liable for failing to detect mismanagement or dishonesty of a bank cashier that likely would have occurred anyway); Hathaway v. Huntley, 284 Mass. 587, 590-91, 188 N.E. 616, 619 (1933) (finding a director who was the wife of a corporate president not liable for her husband's overdrafts because they did not affect the solvency of the corporation); cf. Coffee, supra note 91, at 1213 n.408 (citing cases involving tainted decision making in which causation is clear).

128. See, e.g., Bynum v. Scott, 217 F. 122, 126 (D.N.C. 1914) (finding the directors of a mercantile corporation not liable for employees' mistakes of judgment).

129. Barnes, 298 F. at 616-17.

more common "abetting" cases) and passivity in mixed-motive contexts (the less common and more difficult "due care" cases).

(a) Inattention to palpable diversion.—Although courts rarely find directors liable for inattention to management slackness, they have frequently found directors liable for inattention to management diversion. Courts use the same due care rhetoric in both kinds of cases, but a number of factors, including relaxed causation requirements, demonstrate that they apply a different theory—an abetting theory—to review alleged inattention to diversion. Courts hold directors liable when they knew, or had reason to know, of palpable management diversion. As in the safety valve cases, courts are reluctant to use the business judgment rule's minimal review when the possibility of self-interest exists; yet they are also reluctant to use the loyalty regime's stringent rule without proof that the directors conspired in the diversion. Consequently, liability in abetting cases does not turn on the directors' negligent inattention or on conspiracy. Rather, liability is based on an intermediate review of the merits of the directors' failure to stop the diversion.131

Almost invariably, abetting cases (most of them predating national banking regulation) concerned directors of financial institutions who allegedly failed to notice defalcating cashiers, treasurers, and presidents.132 For example, in the early, oft-cited case of *Marshall v. Farmers' & Mechanics' Savings Bank,* the Virginia Supreme Court held bank directors personally liable for failing to notice the bank president's hand in the corporate till, literally and figuratively. The president had taken

131. An intermediate substantive review standard and relaxed causation requirements are consistent with the premises of fiduciary regulation. Shareholders expect courts to treat diversion differently from wholesome ineptitude, and judicial intervention and the imposition of personal liability for diversion do not deter risk taking. See supra subsection I(B)(3).

132. See, e.g., Bowerman v. Hamner, 250 U.S. 504, 513 (1919) (holding the defendant director liable for failing to attend board meetings and inform himself on bank's condition such that he could have detected illegal loans made by president); Atherton v. Anderson, 99 F.2d 883, 892 (6th Cir. 1938) (holding a director's estate liable for the director's failure to supervise speculations by a bank president); Doyle v. Union Ins. Co., 202 Neb. 599, 612-13, 277 N.W.2d 36, 44 (1979) (holding directors liable for oversights in approving the transfer of assets to a company in which the president had an undisclosed interest); Kavanaugh v. Gould, 223 N.Y. 103, 116-17, 119 N.E. 237, 241 (1918) (holding an absentee director liable for failing to supervise self-dealing and illegal transactions); Harris v. Pearsall, 116 Misc. 366, 383-84, 190 N.Y.S. 61, 71 (Sup. Ct. 1921) (holding directors liable for delegating authority to corrupt managers); Baker v. Mutual Loan & Inv. Co., 213 S.C. 558, 567, 50 S.E.2d 692, 695-96 (1948) (holding directors liable to a receiver for declaring an illegal dividend in reliance on a defrauding promoter); Neese v. Brown, 218 Tenn. 686, 698, 405 S.W.2d 577, 583-84 (1964) (holding directors liable to a bankruptcy trustee for failing to devote time to or keep informed about the business, for abdicating management to the president, and for permitting loans to unsound companies controlled by the president); cf. Tri-Bullion Smelting & Dev. Co. v. Curtis, 186 A.D. 613, 626, 174 N.Y.S. 830, 839, aff'd, 230 N.Y. 629, 130 N.E. 921 (1919) (holding directors liable for failing to uncover the scheme of a mining corporation's treasurer to steal corporate funds).

133. 85 Va. 676, 688-89, 8 S.E. 586, 592 (1889).
money from the cash drawer and had engaged in self-dealing through a series of unsecured and unpaid loans to the president’s brother and to companies in which the president had interests. 134 Assuming *arguendo* the directors’ asserted ignorance, the court nonetheless concluded that “[t]heir duty required that they should have looked well into all these matters.” 135 In truth, the court believed that the directors knew of the diversion. 136 The procedural care rhetoric provided a convenient tool for imposing personal liability on directors as abettors who likely knew of and could readily have avoided the prohibited diversion. 137

Besides the greater frequency of liability in abetting cases, another factor demonstrating that courts apply a different standard is that the likelihood of liability decreases as defendants know less about the diversion. In fact, many courts now accept ignorance as an excuse for inattention to diversion. 138 Courts judge the merits of a director’s failure to act by considering his position, the circumstances, and the degree of knowledge he has (or likely has) about the diversion. Inside directors and officers, because of the greater likelihood that they are aware of the

134. *Id.* at 678-80, 8 S.E. at 587-88.
135. *Id.* at 688, 8 S.E. at 592.
136. See *id.*
137. See also *DePinto v. Provident Sec. Life Ins. Co.*, 374 F.2d 37, 43 (9th Cir.) (holding director liable for assisting in the transfer of controlling stock without investigating adverse effects), cert. denied, 389 U.S. 822 (1967); *Gamble v. Brown*, 29 F.2d 366, 374-75 (4th Cir. 1928) (holding bank directors liable for failing to check excessive loans after warnings by a bank examiner), cert. denied, 279 U.S. 839 (1928); *Bixby*, 276 F. Supp. 217, 231 (E.D. Mo. 1967) (holding directors liable for failing to prevent improper commissions to officers after being presented with concrete evidence of impropriety).
138. See, e.g., *Briggs v. Spaulding*, 141 U.S. 132, 154 (1891) (finding no liability because no evidence existed that the defendant bank director was aware of management defalcations); *Drexl & Co.* v. *Lanza*, 479 F.2d 1277, 1292 (2d Cir. 1973) (same) (quoting *Dovey v. Cory*, [1901] App. Cas. 477, 486 (“If Mr. Cory was deceived by his own officers ... there appears ... to be no case against him at all.”)); *Barnes v. Andrews*, 298 F. 614, 616 (S.D.N.Y. 1924) (L. Hand, J.) (holding that an ignorant accommodation director was not liable for failing to investigate false statements in an investment circular); *Cornick v. Weir*, 212 Iowa 715, 729-30, 237 N.W. 245, 251 (1931) (finding no liability because bank directors did not have actual knowledge of the misuse of bonds deposited as collateral); *Taylor v. Alston*, 79 N.M. 643, 645, 447 P.2d 523, 525 (Ct. App. 1968) (requiring actual participation or knowledge amounting to acquiescence to support a claim against directors); *Mason v. Moore*, 73 Ohio St. 275, 290-91, 76 N.E. 932, 936 (1906) (holding bank directors who did not know of or have reason to suspect cashier’s false entries not liable). The premises of the fiduciary model compel a scienter requirement: the possibility of liability for ignorant nonsupervision could promote deadening caution and meaningless layers of procedure, and could even discourage directors from service. *Lanza*, 479 F.2d at 1307. In earlier cases such as *Marshall*, imposing abetting liability on ignorant directors may not have been an inefficient or unfair allocation of risk, because only directors were generally both significant shareholders and insiders likely to know about or even participate in the diversion. *See Marshall*, 85 Va. at 688, 8 S.E. at 592; see also *Francis v. United Jersey Bank*, 87 N.J. 15, 39-40, 432 A.2d 814, 826 (1981) (holding a director liable for a corporation’s losses because she failed to use reasonable care in discovering a fraudulent scheme involving other directors of the corporation). The imposition of liability in these cases avoided having nondirector shareholders and creditors share in the directors’ tacit generosity.
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diversion, are more likely to be held liable than outside directors. Bates v. Dresser illustrates these aspects of an abetting theory. In Bates, the Supreme Court exonerated the directors of a bank for failing to inquire into bank books that would have revealed embezzlement by the bank's cashier. The Court concluded that “[t]heir confidence seemed warranted by the semi-annual examinations by the government examiner and . . . the president, whose responsibility, as executive officer; interest, as large stockholder and depositor; and knowledge, from long daily presence in the bank, were greater than theirs.” The bank president, however, who had “hints and warnings” of embezzlement, was held liable. The circumstances under which the inaction occurred, not the level or lack of inquiry, explain the outcome.

The relaxed notions of causation that courts apply in these cases also demonstrate that a different standard controls. In Francis v. United Jersey Bank, the widow of the founder of Pritchard & Baird, a closely held reinsurance brokerage business, had failed to read the firm’s annual financial statements, which revealed that her sons were misappropriating client funds in the guise of “shareholder loans.” Mrs. Pritchard was in-

139. The view that outside directors have less demanding duties of supervision is well established. See, e.g., Rowen v. Le Mars Mut. Ins. Co., 282 N.W.2d 639, 652-53 (Iowa 1979) (holding that outside directors do not have same supervisory responsibility as those actively in charge and can rely on management until they have reason to suspect diversion). Courts have held outside directors liable when the context revealed obvious diversion of which they must have been aware. See McDonnell v. American Leduc Petroleums, Ltd., 491 F.2d 380, 382-85 (2d Cir. 1974) (holding a “passive” president and director with “little business experience” liable for failing to notice violations of the orders of the California Division of Corporations with respect to the company’s loan-making policies); Gamble v. Brown, 29 F.2d 366, 373 (4th Cir. 1928) (holding an aged and infirm director liable for not noticing excessive loans despite warnings by bank examiner); Gallin v. National City Bank, 155 Misc. 880, 892-93, 281 N.Y.S. 795, 807-08 (Sup. Ct. 1935) (holding outside director liable for approving a bonus plan based on false figures from management); Neese v. Brown, 218 Tenn. 686, 689-95, 405 S.W.2d 577, 579-81 (1964) (holding a director liable for, among other things, permitting unsound loans to companies controlled by the president); cf. Harman v. Willbern, 374 F. Supp. 1149, 1163 (D. Kan. 1974) (holding a director on the board “in name only” not liable for relying on looting officers); Anderson v. Akers, 7 F. Supp. 924, 936 (W.D. Ky. 1934) (holding a director of “unsound mind” not liable for damages resulting from the ultra vires acts of a bank in violation of the National Banking Law), aff’d in part and rev’d in part, 86 F.2d 518 (6th Cir. 1936), rev’d in part per curiam, 302 U.S. 643 (1937); Taylor, 79 N.M. at 643, 645-46, 447 P.2d at 525-26 (holding nonmanaging directors not liable but refusing to dismiss claim against the managing director who participated in day-to-day operations). The same distinction underlies the federal securities doctrine that nonmanaging directors’ duties of diligence are less stringent than those of management. See Lanza, 479 F.2d at 1281; Gould v. American Hawaiian S.S. Corp., 351 F. Supp. 853, 865 (D. Del. 1972); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 578 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682-89 (S.D.N.Y. 1968); see also Small, supra note 91, at 1369-70 (indicating that nonmanaging directors should be allowed to rely on the reports of management and should be required to verify independently only in unusual cases where the facts indicate it is appropriate).

140. 251 U.S. 524, 529-30 (1920).
141. Id. at 530.
142. Id. at 530-31.
active and knew virtually nothing about the business; before his death, however, Mr. Pritchard had warned her that their sons would "take the shirt off my back." In this tainted context, the court held that she was liable for having failed to make greater inquiries. In reaching this decision, the court applied a more lenient causation standard than applies in untainted inattention cases. While recognizing that "proximate cause is especially difficult in a corporate context where the allegation is that nonfeasance of a director is a proximate cause of damage to a third party," the court held that causation could be inferred, because it was reasonable to conclude that Mrs. Pritchard could have deterred her sons' misappropriation. Such an inference is inappropriate in untainted enterprise contexts.

In each of these cases, while using the rhetoric of a duty to be informed, the courts in truth reviewed the substance of the directors' failures to stop the diversions, finding liability when knowing inaction was inexcusable under the circumstances. Directors cannot avoid liability merely by making the proper inquiries.

These observations suggest that abetting liability in the modern public corporation may be at most of limited relevance. Because the modern

144. Id. at 26, 432 A.2d at 816.
145. Id. at 27, 432 A.2d at 819.
146. The case does not, however, broadly imply a duty of inquiry whenever diversion is possible. A bankruptcy trustee brought the suit against the widow and her two sons, the only directors. During the proceedings the widow, who had become listless and who started to drink heavily after her husband's death, died, and the suit proceeded against her estate. See id. at 20, 432 A.2d at 816. The court may have reached the result it did to add the estate's assets and the widow's insurance coverage to the bankruptcy pool. This result may have seemed especially just if the defalcating sons were their mother's beneficiaries. In a virtually identical case, a court denied recovery against a wife acting as a "nominal director" who had failed to notice or prevent her husband's personal withdrawals from a family trucking corporation. See Allied Freightways v. Cholfin, 325 Mass. 630, 633, 91 N.E.2d 765, 768 (1950); see also Kohl v. F.J.A. Christiansen Roofing Co., 95 Wis. 2d 27, 36, 289 N.W.2d 329, 334 (1980) (holding that the knowledge of a particular occurrence will not be imputed to a director "until after an examination of the duties of directors . . . and after the fact finder has had an opportunity to determine whether diligence in performing those duties would have provided disclosure"). Although Francis might be read as eviscerating an ignorance defense, see Dyson, supra note 120, at 363-64, it can and should be limited to its special facts. The failure of the ignorance defense as to Mrs. Pritchard may simply reflect that recovery against her estate was recovery indirectly against her embezzling sons, for whom no such defense could be made.
147. Francis, 87 N.J. at 44-45, 432 A.2d at 829.
148. Id. at 24-27, 432 A.2d at 818-19.
149. See, e.g., Barnes v. Andrews, 298 F. 614, 616 (S.D.N.Y. 1924) (holding that this inference was unwarranted when business failure resulted from "general mismanagement, business incapacity, or bad judgment"); Allied Freightways, 325 Mass. at 634, 91 N.E.2d at 768 (holding that a wife who acted as a "nominal director" was not liable for failing to notice or prevent her husband's personal withdrawals because even if she had been diligent, it was "doubtful [that] she could have changed the situation").
150. Francis, 87 N.J. at 41, 432 A.2d at 827 (quoting Barnes, 298 F. at 616-17).
board, dependent on management for information, will usually have a defense of ignorance, and because modern management has fewer incentives to risk fraudulent diversion given their broad opportunities for rich compensation, abetting liability in modern public corporations may be an anachronism. Nonetheless, the abetting cases demonstrate the malleability of the care regime and, under closer scrutiny, its real indifference to the process of decision making. The relevant question has not been how much directors inquired, but how much they knew and what they did—a review of the merits of their failure to act. When directors know of diversion, heightened standards judge their inaction.

(b) "Due care" in mixed-motive contexts.—In contexts in which management’s motives are unclear or mixed—suggesting both interested and enterprise motives

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152. See, e.g., Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 274-75 (2d Cir. 1986) (takeover case relying on Manheim Dairy Co. v. Little Falls Nat'l Bank, 54 N.Y.S.2d 345 (Sup. Ct. 1945), which involved a failure to notice a bank treasurer's embezzlement); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (takeover case relying on Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (1961), which concerned a failure to supervise an illegal self-dealing management transaction by mutual fund's advisor); see also Phillips, supra note 100, at 203-04 (noting that courts use "duty of care as a substitute for duty of loyalty when evidence" proving the latter is absent).

153. See Mitchell v. Highland-Western Glass Co., 19 Del. Ch. 326, 331-32, 167 A. 831, 833 (1933). The analogous "reasonable investigation" standard used in the takeover defense cases may have defense cases may have developed because courts felt incompetent to judge the fairness of takeover defenses. See Gilson, supra note 68, at 828 (discussing Cheff v. Mathes, 41 Del. Ch. 494, 505, 199 A.2d 548, 555 (1964)).
ing interests or into the adequacy of a transaction’s terms.\textsuperscript{154} An early, and isolated, illustration is \textit{Mitchell v. Highland-Western Glass Co.},\textsuperscript{155} in which shareholders challenged the adequacy of consideration in a sale of assets in which management had been promised positions with the purchasing corporation.\textsuperscript{156} The court accepted as plausible that the business judgment rule may offer no protection for “an unintelligent or unadvised judgment” but concluded without analysis that the directors had been sufficiently informed about the value of the assets.\textsuperscript{157} As to the challengers’ “main contention” that the consideration was inadequate, the court held first that there was insufficient evidence of self-dealing to warrant a fairness review\textsuperscript{158} and then held that the consideration was adequate.\textsuperscript{159}

\textit{Smith v. Van Gorkom}, the 1985 bombshell dropped by the Delaware Supreme Court, murkily (but powerfully) demonstrates the use of due care standards to mask greater substantive review. Purporting to apply procedural care standards, the court in a 3-2 decision overturned a friendly cash-out merger that offered shareholders a forty to sixty percent premium over prevailing market prices for their stock.\textsuperscript{160} Undoubtedly, it is desirable that managers be allowed to initiate and negotiate such deals. But the court took an unprecedentedly jaundiced view of the approval of the transaction by Trans Union’s disinterested board.

The sequence of events, described in great detail (though some have said inaccurately\textsuperscript{161}) in the court’s opinion, paints a picture of a chief executive officer (Van Gorkom) who initiated, negotiated, and pushed through a deal whose terms on close inspection may have been one-sided. Van Gorkom was reaching retirement age, and he stood to gain about 1.5

\textsuperscript{154.} The due care argument seems to be a product of and largely limited to cases in the control context, in which fairness challenges have faced a difficult road. See, e.g., Cheff v. Mathes, 41 Del. Ch. 494, 505, 199 A.2d 548, 554-55 (1964) (finding no interest sufficient to trigger loyalty review when directors bought out a minority shareholder at a premium in order to prevent his taking over the company); \textit{Hanson Trust}, 781 F.2d at 274-75 (enjoining lockup options on procedural care grounds but finding no interest sufficient to trigger fairness review).

\textsuperscript{155.} 19 Del. Ch. 326, 327-28, 167 A. 831, 832 (1933).

\textsuperscript{156.} The due care aspect of the case was virtually ignored until 1985 when \textit{Smith v. Van Gorkom} revived it. See \textit{Smith v. Van Gorkom}, 488 A.2d 858, 872 (Del. 1985); cf. \textit{Gimbel v. Signal Cos.}, 316 A.2d 599, 609 (Del. Ch.) (citing \textit{Mitchell} but downplaying its relevance), \textit{aff’d on other grounds}, 316 A.2d 619 (Del. 1974).

\textsuperscript{157.} Mitchell, 19 Del. Ch. at 330, 167 A. at 833.

\textsuperscript{158.} Id. at 331, 167 A. at 833. This result under Delaware case law seemed preordained and perhaps explained the challengers’ recourse to a due care theory. See Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 324, 147 A. 257, 260 (1929) (not inferring a self-dealing motive when a majority shareholder arranged a sale of assets to a corporation in which he was to become a field manager).

\textsuperscript{159.} Mitchell, 19 Del. Ch. at 329-30, 147 A. at 263.

\textsuperscript{160.} \textit{Van Gorkom}, 488 A.2d at 843.

\textsuperscript{161.} See, e.g., Manning, \textit{supra} note 3, at 3.
million dollars from the merger’s premium.\textsuperscript{162} The negotiation process and his indifference to finding another buyer\textsuperscript{163} suggest that he had reached an understanding with the acquiror Pritzker, a prominent investor and a personal acquaintance of Van Gorkom.\textsuperscript{164} Also, a merger is hardly a typical enterprise decision and necessarily impinges on shareholders’ control of their investment.

But neither care review of the merger’s merits nor loyalty review under the traditional dichotomous fiduciary model is designed to take such factors into account. The merger’s forty to sixty percent premium conditioned on a test-market period during which Trans Union was to seek other bids unquestionably indicated a rational business purpose. The merger was also subject to shareholder approval. And as the court pointed out, there were “no allegations of fraud, bad faith, or self-dealing, or proof thereof.”\textsuperscript{165} All that was left under the dichotomous fiduciary model was procedural due care review. Applying Delaware’s standards—which the court said were based on “concepts of gross negligence”\textsuperscript{166}—the court held that the directors were liable for deliberative lapses in approving the merger.

The court rejected a number of arguments, any one of which would have been more than sufficient in a traditional care case to foreclose further inquiry: that the price reflected a significant premium and was within internally calculated leveraged buyout ranges;\textsuperscript{167} that the directors had justifiably relied on Van Gorkom;\textsuperscript{168} that the directors had significant business expertise and background knowledge of the business;\textsuperscript{169} that approval was conditioned on a test-market period;\textsuperscript{170} that the board was operating under the time pressure of Pritzker’s deadline;\textsuperscript{171} that outside counsel had advised the directors that they might be sued for turning away an attractive offer;\textsuperscript{172} and, the shareholders, approval of the merger had effectively waived any inadequacies of the deliberations surrounding the agreement’s approval.\textsuperscript{173} The transaction could easily have

\textsuperscript{162} See Van Gorkom, 488 A.2d at 865-66 (pointing out that Van Gorkom held 75,000 shares and finding it “noteworthy” that Van Gorkom was reaching retirement age).

\textsuperscript{163} See id. at 885 (viewing the test-market condition as “virtually meaningless” because of the terms and time limits of Trans Union’s merger agreement with Pritzker).

\textsuperscript{164} See id. at 885.

\textsuperscript{165} See id. at 866.

\textsuperscript{166} See id. at 866.

\textsuperscript{167} See id. at 876-77.

\textsuperscript{168} See id. at 877.

\textsuperscript{169} See id. at 880.

\textsuperscript{170} See id. at 878-80.

\textsuperscript{171} See id. at 875.

\textsuperscript{172} See id. at 881.

\textsuperscript{173} See id. at 873, 888.
been upheld on rational basis grounds. Instead, the court recited a litany of Van Gorkom’s oversights, none of which the passive board had recognized and all of which, in the court’s eyes, negated the reasonableness of the board’s reliance: Van Gorkom had failed to notify the board of the reason for the meeting to consider the merger proposal; he never explained that he, not Pritzker, suggested the fifty-five dollar price; he had not read the merger documents; he did not seek an investment banker’s opinion on the company’s entity value; he failed to consult with management; and he did not mention to the board that senior management had strenuously objected to some aspects of the agreement. The board had also failed to review documents, to inquire into the basis for internal leveraged buyout valuations, and to consider the tax implications of a cash-out merger.

Many have criticized the court’s stridency, arguing that it is unbecoming of care review. But Smith v. Van Gorkom was not a duty of care case—or at least not one for which the business judgment rule was designed. Consider this question: what if the board had asked, read, and heard those things it was charged with having failed to question? At worst, the directors would have discovered that Van Gorkom had negotiated on his own initiative a deal with a personal and business acquaintance, had proffered during the negotiations a price at the low end of an acceptable range, and had agreed to a merger with some disadvantageous terms to which senior management objected. The court could not have viewed the merger’s approval, even after full disclosure, as improvident beyond explanation. There is little reason to believe, much less to be confident, that a better-informed board would have been able to extract a better deal. And the business judgment rule teaches that in an enterprise context an inquiry into such a fine question is not for the courts.

The Van Gorkom court’s failure to consider this analysis suggests that it in fact applied a higher substantive standard. Van Gorkom’s “fast shuffle”—a characterization that the dissent used to explain the major-

174. See id. at 867.
175. See id. at 877.
176. See id. at 879.
177. See id. at 878.
178. See id. at 882.
179. See id. at 875-77.
180. See, e.g., Fischel, supra note 3, at 1455 (asserting that the Delaware Supreme Court “has never fully understood that allowing individual shareholders . . . greater ability to sue directors . . . is not in the best interest of shareholders as a class”); Herzel & Katz, Smith v. Van Gorkom: The Business of Judging Business Judgment, 41 Bus. LAW. 1187, 1189 (1986) (stating that the Van Gorkom decision rests “on a simple misunderstanding (and fallacy) of how the world works: how business decisions are made, how bargains are struck”); Manning, supra note 3, at 3 (noting that the Van Gorkom decision “exploded like a bomb”).

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itiy's vehemence—might have justified such a standard. But just as plausible, the standard reflects the greater potential for mixed motives and the fewer reasons for applying the forgiving presumptions of the business judgment rule in the context of a merger. Control decisions inevitably implicate shareholder “ownership claim issues” and management continuity, not just traditional enterprise questions. The statutory governance structure that requires shareholder approval of mergers supports less deferential review. Statutory appraisal remedies also reflect a perception that, compared to directors, courts in the merger context can do a relatively competent job of deciding questions of shareholder value. These reasons justify reviewing the merits of the board’s failure to have sought a better price.

The court’s emphasis on boardroom procedures and the attendant care rhetoric is unfortunate, but not necessarily an unmitigated disaster. So long as planners, legislators, and courts can plumb the meaning of the case, the decision may reflect little more than the fits and starts of common-law jurisprudence. But they have not yet fully done so.

181. See Van Gorkom, 488 A.2d at 894 (McNeilly, J., dissenting).
183. Manning, supra note 3, at 6 (differentiating between “enterprise issues” and “ownership claim issues,” which involve “the personal property of the shareholders” and which arise in “stock issuance, redemption, cashout, reverse split, [and] merger” decisions); see also Fisher v. Plessey Co., 559 F. Supp. 442, 449 (S.D.N.Y. 1983) (noting that directors’ discretion is limited when the corporation is buying back its own debentures).
184. Johnson & Siegel, supra note 182, at 318.
185. Commentators have assumed Van Gorkom was a case about the process of decision making. See, e.g., King, Director Protection Under Virginia Law, 20 REV. SEC. & COMMODITIES REG. 129, 130 (1987) (stating that well-intended conduct by highly qualified directors has been scrutinized for lacking reasonable deliberation); Manning, supra note 3, at 4 (predicting that Van Gorkom will be fitted “into the mainstream of business judgment rule jurisprudence, with its emphasis . . . on the process by which the decision was made”); cf. Manning, supra note 13, at 1498 ( foreseeing an unfortunate case in which a court “will read literally the judicial dicta” on the director’s duty of care). Legislatures, too, have understood it as a care case. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (1986) (authorizing charter amendments eliminating or limiting the personal liability of directors resulting from a breach of fiduciary duty); see also Lee, Limiting Corporate Director Liability, 136 U. PA. L. REV. 239, 249 (1987) (agreeing with Manning that Van Gorkom is not an extension of duty of care liability, but an application that will lead to greater emphasis on the process of decision making in the future). In response to Van Gorkom, commentators and practitioners have assembled checklists of “good” and “bad” boardroom practices. See, e.g., Brownstein, Takeovers and the Business Judgment Rule, 20 REV. SEC. & COMMODITIES REG. 177, 180-82 (1987); Manning, supra note 3, at 3, 8-14. But courts have been more sanguine. If the Trans Union board’s deliberations were typical, and they likely were, see Manning, supra note 13, at 1490-95, the virtual absence of any due care cases other than defensive tactic and derivative suit dismissal cases is telling. In one of the few recent cases brought on a Van Gorkom theory, the court upheld as reasonable on the merits a board’s recommendation of a tender offer made by a 48.8% shareholder. Citron v. Steego Corp., Civ. A. No. 10171 (Del. Ch. Sept. 9, 1988) (WESTLAW, Decs database) (Allen, J.). The court found that the company, which was in bad financial shape, would probably not have found another bidder, that the tender offer provided shareholders a significant premium, and that the company’s executives had tendered their shares. Despite the board’s failure to consult an investment banker,
Not even the Van Gorkom court understood what it was doing. In remanding the case, the court implied that the lower court should base damages on the same measure applied in loyalty cases—the difference between the price actually received and the optimum price that an arm's-length transaction would have yielded.\textsuperscript{186} Such an approach fails to recognize the special nonloyalty context in which the Trans Union management and directors were operating. Shareholders expect, and the contractarian and efficiency premises demand, some deference to management decisions in initiating and negotiating mergers. The transaction should have stood, even if the merger price was below the market optimum, as long as the price and terms indicated that the transaction was structured primarily for the benefit of shareholders rather than managers or directors.\textsuperscript{187} Applying something between a forgiving rational basis standard and an uncompromising fairness test is appropriate. Neither a care feather nor a loyalty bludgeon, but instead an independence scalpel should identify whether the merger terms were aimed principally at promoting shareholder welfare.

3. Conclusion: A Duty of Independence.—Judicial perceptions of the board's monitoring capacity and a directorial duty of independence provide a useful framework for explaining most cases in which courts have imposed care liability. Specifically, in safety valve cases (involving inferable but unproved conflicts), abetting cases (involving knowing inattention to diversion), and due care mixed-motive cases, it may be more descriptive to say that directors failed in their monitoring function—that is, that they failed to remain detached in the face of actual or inferable conflicting interests. None of the cases, however, finds a niche in the classic care regime. Further, central to each line of cases is an evaluation

the court's review of the board's deliberative process seemed an afterthought. Van Gorkom in all likelihood was simply a volley across the dichotomous fiduciary model's bow. See Macey & Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 TEXAS L. REV. 469, 519 n.194 (1987) (recounting comment by Justice Moore of the Delaware Supreme Court during oral arguments on another case that "there will never be another Van Gorkom"). Taking a more realistic view of the case, some commentators have explained it as a means chosen by the Delaware Supreme Court to stave off federal intervention and to maintain the preeminence both of Delaware's corporate legal rules and of the Delaware corporate bar that interprets them. See Macey & Miller, supra, at 519; see also Greene & Palmiter, Business Judgment Rule Tightened for Takeovers, Legal Times, Jan. 20, 1986, at S3, col. 1 (stating that the Van Gorkom court used the case "to assert itself and in effect to deny the accusation of its own passivity").

\textsuperscript{186} See Van Gorkom, 488 A.2d at 864; Manning, supra note 3, at 4.

\textsuperscript{187} Certainly, at the least it would have been appropriate for the court to have considered the expected value of Trans Union's accumulated investment tax credits assuming less than an optimal acquiror. See Van Gorkom, 488 A.2d at 876 (noting that the board did not study or take "into account that highly significant element of the Company's assets").
(usually tacit) of directorial independence: the rhetoric of care and business judgment is misplaced.

The faltering history of care liability also reveals that courts, in measuring independence, have been moved by the substantive sufficiency of the directors' action or inaction. Emphasis on due care investigation and deliberative procedures requires a more searching judicial inquiry of the merits of the decision. The seeming lesson of Smith v. Van Gorkom that boardroom "due process" may insulate board decision making from attack is misleading, particularly in contexts in which motives are predictably mixed. The due care rhetoric is a poor vehicle for defining the board's monitoring functions.

B. The Loyalty Regime: Ambivalence Toward the Board's Monitoring Function

The loyalty regime's evolution reflects two salient aspects of the fiduciary model that are relevant to recognizing and fashioning a duty of independence. The most significant is the increasing deference to management prerogatives reflected in the steady, nearly inexorable, relaxation of the standards that courts have used to review conflict of interest transactions. The second is the nearly century-long judicial questioning of the board's monitoring capacity. Courts have been skeptical about validation by disinterested directors of conflict of interest transactions and doubtful about the efficacy of judicial scrutiny of the process of corporate decision making. Process review in the loyalty regime, as in the care regime, often seems empty—a surrogate for substantive inquiry. In reality, process has provided little more than a useful road map for judicial review of a decision's substantive adequacy. It has not been a determinative indicia that a transaction has maximized shareholder wealth.

I. From Automatic Voidability to "Validation Plus Fairness".—In large measure because of the distrust of disinterested validation and the board's monitoring capacity, early courts fashioned a simple and eminently administrable rule of corporate law: self-dealing by directors

188. Harold Marsh first laid out the evolution of the loyalty regime in 1966. See Marsh, supra note 41, at 36-53. Other commentators have described more recent developments. See, e.g., Cary, Federalism and Corporate Law: Some Reflections upon Delaware, 83 YALE L.J. 663, 670 (1974) (noting that Delaware courts have "generally... relaxed" the standards of fairness); Phillips, supra note 100, at 188-90, 194-97 (describing the movement away from principles of trust toward principles of fairness and courts' failure to explain the transition adequately).

189. Courts derived the rule largely from extant agency, partnership, and, most importantly, trust principles. See Tent. Draft No. 5, supra note 39, introductory note a, at 15; Brudney, supra note 14, at 1407-08, 1407 n.15.
and managers was flatly prohibited and was void or voidable at the instance of the corporation.\textsuperscript{190} On contractarian, efficiency, and prudential grounds, a flat prohibition had and still has great allure. It avoids shareholders' having to anticipate and contractually regulate the myriad ways in which directors might deal for themselves, it leaves directors no room to maneuver, and it ensures streamlined judicial review. Its only costs to the corporation are the occasional lost opportunities of possibly unique or especially beneficial self-dealing transactions.

The flat prohibition also reflected a judicial recognition of the weakness of human character—a concept with old moral roots\textsuperscript{191} and the cornerstone of corporate fiduciary regulation. Disinterested validation was rejected out of hand. Courts were understandably skeptical of the ability of "disinterested" directors to be guided by loyalty to the corporation rather than by their loyalties to interested colleagues. To have sanctioned disinterested validation would have invited fraud and venality.\textsuperscript{192}

Soon after the turn of the century, a new rule dramatically reversed and disavowed the underpinnings of the original rule of voidability. The new rule allowed interested transactions that were (1) approved by a majority of disinterested directors and (2) shown to a court's satisfaction to be fair.\textsuperscript{193} Many have reviled this abrupt, largely unacknowledged change, some pointing out sarcastically that there was no reason to be-

\textsuperscript{190} See 3 W. FLETCHER, supra note 41, § 917, at 496; Marsh, supra note 41, at 36; Phillips, supra note 100, at 187; see, e.g., Bosworth v. Allen, 168 N.Y. 157, 167, 61 N.E. 163, 165 (1901) (holding directors liable for misappropriating assets of the corporation for their own benefit); Luther v. C.J. Luther Co., 118 Wis. 112, 124-25, 94 N.W. 69, 73 (1903) (invalidating a stock issue designed to shift corporate control from one faction of directors to another).

\textsuperscript{191} The duty of loyalty is necessarily "derived from a profound knowledge of human characteristics and motives." Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939). In an early and famous fiduciary case involving an executor who purchased for himself property he was obligated to sell, the United States Supreme Court observed:

-The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity... In this conflict of interest, the law wisely interposes. It acts not on the possibility, that, in some cases, the sense of that duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.


\textsuperscript{192} It would place disinterested directors in an "embarrassing and invidious position" to require them "to pass upon, scrutinize and check the transactions and accounts of one of their own body." Cumberland Coal & Iron Co. v. Parish, 42 Md. 598, 606 (1875), quoted in Marsh, supra note 41, at 37.

\textsuperscript{193} Marsh concluded that this two-pronged test had become the general rule by 1910. See Marsh, supra note 41, at 39-40; W. CLARK, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS § 202, at 642 n.99 (3d ed. 1916).
lieve that human nature had been reborn. Yet the change was consistent with other developments in corporate law. The discretion increasingly afforded corporate managers parallels the explanations offered for the new "validation plus fairness" rule: the unique advantages of certain self-dealing transactions, such as compensated employment of directors, directors' loans to the corporation, and transactions between corporations with interlocking directors; the ubiquity of the practice of disinterested validation; a desire to encourage a cadre of professional (though often interlocking) directors in public corporations; the perception that shareholder governance was efficacious; and the ascendency of "managerial capitalism."

194. See Anderson, supra note 55, at 783 (arguing for a prohibition on self-dealing unless a transaction could be shown to be "unequally valuable to the corporation"); Brudney, supra note 10, at 611 n.42 ("No recent evidence suggests that the ancient wisdom was wrong."); Marsh, supra note 41, at 40 ("One searches in vain in the decided cases for a reasoned defense of this change in legal philosophy . . . .").


This increasing discretion coincides with a contemporaneous loosening of the prohibition against self-dealing in trust law. One turn-of-the-century court justified disinterested validation by analogy to a trustee's newly recognized ability to deal with the cestui que trust if explicitly allowed, or disclosed and not unfair. See Tenison v. Patton, 95 Tex. 284, 292-93, 67 S.W. 92, 95-96 (1902), discussed in Marsh, supra note 41, at 40 & n.19; see also Restatement (Second) of Trusts §§ 170, 216 (1959) (providing that "[t]he trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary" and that the beneficiary's consent will relieve the trustee of liability); Uniform Trusts Act §§ 8, 18 (1937) (proscribing the sale or purchase of any trust property to or from the trustee or an affiliate, except when the beneficiary has relieved the trustee of this restriction). Professor Clark explains these changes as part of a much larger pattern in which the law was becoming less absolute and rigid. R. Clark, supra note 33, § 5.1, at 162.


197. "Common directors abound, and common directors are better than 'dummies.'" Robotham v. Prudential Ins. Co. of Am., 64 N.J. Eq. 673, 709, 53 A. 842, 856 (Ch. 1903), quoted in Marsh, supra note 19, at 41 n.21.

198. Professor Clark makes the interesting observation that the shift may have arisen because the eighteenth century "voidability" cases generally involved public corporations, while the "validation plus fairness" cases generally involved closely held corporations. In a public corporation, the availability of noninsider sources and the diffusion of shareholder oversight suggest that self-dealing has little wealth-maximizing potential—prohibition is not costly. In a close corporation, insider opportunities may be uniquely beneficial—prohibition can be costly—and shareholders will generally be in a better position to prevent diversion. R. Clark, supra note 33, § 5.1, at 164-66. Others have argued that shareholders are better able to protect themselves from self-dealing than are the prototypical trust beneficiaries (widows and minors). See, e.g., Phillips, supra note 100, at 192. Moreover, the courts that adopted the "validation plus fairness" standard could take heart that shareholders had not risen in protest and that capital formation had apparently not dried up, indicating that the new rule had not allowed systemic abuse.

199. See A. Chandler, The Visible Hand: The Managerial Revolution in American Business 491-93 (1977). The displacement of the voidability rule was consistent with the evolving view of the modern corporation, away from a vehicle for shareholder investment and toward a means for managerial control of the factors of production. See A. Berle & G. Means, supra note 12, at 220-32. Some have postulated that the ascendency of "managerial capitalism" was achieved
In addition, the breadth of the flat prohibition may have led to its demise. Once courts abandoned the voidability rule in some contexts, such as transactions between corporations with interlocking directors or self-dealing in closely held corporations with limited outside sources, they became more likely to apply the new “validation plus fairness” test in all self-dealing contexts. The articulated standards of loyalty review, like care review, have generally become all-encompassing, applicable equally in all interested contexts.

Modern statutes codify at least part of this first stage of displacement. Under recently enacted statutes, a conflict of interest transaction is not automatically voidable so long as the transaction either was approved by informed and disinterested directors or shareholders, or is judicially determined to be fair. The statutes, however, do not provide standards of loyalty review or procedures for validating self-dealing transactions.

Under the “validation plus fairness” two-pronged test, courts judged the sufficiency of disinterested validation according to the nature and timing of disclosure, the extent of the interested director's participation, and the relationship of the disinterested directors to the transaction and to the interested director. The issue of whether interested directors could be counted for quorum purposes became important.

But disinterested validation during this phase may have had little actual normative significance. In citing to deficiencies in the validation process as a basis for voiding interested transactions, the courts seemed concerned not so much with the process as with the substance of the transaction. The New York Court of Appeals decided three cases through judicial and legislative capture. See R. CLARK, supra note 33, § 5.1, at 162 (suggesting that this “legal criticism” is too nebulous).


201. See, e.g., Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 491, 121 N.E. 378, 380 (1918) (requiring fairness despite independent ratification because in reaching its decision, the ratifying committee depended entirely on the superior knowledge of an interested party).

202. See, e.g., Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 491, 121 N.E. 378, 380 (1918) (requiring fairness despite independent ratification because in reaching its decision, the ratifying committee depended entirely on the superior knowledge of an interested party).

203. See, e.g., New York Trust Co. v. American Realty Co., 244 N.Y. 209, 219, 155 N.E. 102, 104 (1926) (requiring an accounting after a self-dealing transaction in which an interested director had acted as negotiator); Globe Woolen Co., 224 N.Y. at 491, 121 N.E. at 380 (holding voidable a transaction between corporations having an interlocking director when the interlocking director, though he did not vote, proposed the transaction and failed to disclose its “one-sided” nature).

204. See Robotham v. Prudential Ins. Co. of America., 64 N.J. Eq. 673, 709, 53 A. 842, 856 (1903); Phillips, supra note 100, at 193.

205. See Phillips, supra note 100, at 193.
tween 1918 and 1942 that illustrate this concern. In his classic opinion in *Globe Woolen Co. v. Utica Gas & Electric Co.*, Judge Cardozo explained that an electric utility board’s validation of a power supply contract was defective because the interlocking director who proposed the contract had failed to disclose that the transaction favored the manufacturing firm in which he was the largest shareholder. But the true mischief was not this lack of candor. Rather, Cardozo’s primary concern was that the contract as structured was likely to create, and did create, mounting losses for the utility. As Cardozo observed, “[t]he unfairness is startling, and the consequences have been disastrous.” The process of approval masked the underlying substantive unfairness, but its normative relevance is questionable. Had the contract proved to be profitable, the interlocking director’s failure to disclose his belief that the contract was one-sided would hardly have justified allowing the utility to welsh on the contract.

Similarly, in *New York Trust Co. v. American Realty Co.*, the Court of Appeals held voidable International Paper’s purchase of timberland from the family trust of a director who “had general charge of such purchases, and exercised a dominant position in relation thereto.” International Paper, however, did not want to rescind the purchases, but instead wanted to recover allegedly “exorbitant” profits that the director had failed to disclose. This, the court held, the corporation could not do unless the director had recently purchased the timberlands with a view to profitable resale. Resale of recently purchased timberlands to the corporation at a markup would provide unassailable evidence of price unfairness—International Paper could just as well have directly purchased the timberlands itself at the lower price. Thus, it was the unfairness of the price for some of the timberlands, rather than overreaching in the negotiations or failed disclosure, that motivated the decision.

In *Everett v. Phillips*, the question of whether deficiencies in the negotiation process alone can justify upsetting an economically fair transaction came to a head. The Court of Appeals focused exclusively on the economic terms and effects of loans negotiated by interlocking directors. It disregarded the negotiation process, in which the directors stood on both sides of the transaction. Instead, the court emphasized that the di-

206. 224 N.Y. at 491, 121 N.E. at 380.
207. 224 N.Y. at 491, 121 N.E. at 380.
208. 244 N.Y. 209, 155 N.E. 102 (1926).
209. Id. at 215, 155 N.E. at 104.
210. Id. at 215-16, 155 N.E. at 104.
211. Id. at 216, 155 N.E. at 105.
rectors held significant amounts of stock in the allegedly disadvantaged corporation and that the loans at issue "were not excessive in relation to the capital assets and the income of the borrower as shown in the borrower's balance sheet."213 By looking solely to the substantive fairness of the transaction, the court effectively rejected the normative significance of the negotiation process.214

The formal adoption and subsequent disuse of a process-oriented validation standard provide an important lesson for fashioning a duty of independence. The "validation plus fairness" stage is best explained as a way station in a common-law tradition. As courts became more adept at examining the substance of self-dealing transactions, process lost its relevance. If nothing else, the lesson seems to be the same one taught in the abetting and mixed-motive care cases—that courts purporting to review process in corporate fiduciary cases should not be taken at their word.

2. The Current (Though Tenuous) Majority Rule: Substantive Fairness.—In the second departure from the automatic voidability rule, an exclusive fairness review displaced the requirement of disinterested validation.215 This stage, which achieved general acceptance by 1960216 and dominance by 1980,217 both reflects further judicial deference to management prerogative218 and suggests a judicial perception that courts lack the capacity to evaluate corporate deliberative processes meaningfully.

"Fairness," which the interested director has the burden of proving,219 has two aspects. The first is an objective test of whether the inter-

213. Id. at 237, 43 N.E.2d at 22.
214. That defects in the negotiation process do not void the transaction was confirmed in Chelrob, Inc. v. Barrett, 293 N.Y. 442, 462, 57 N.E.2d 825, 834 (1944).
215. See 3 W. FLETCHER, supra note 19, § 931, at 538-42; H. HENN & J. ALEXANDER, supra note 19, § 238, at 637-44; G. HORNSTEIN, CORPORATION LAW AND PRACTICE, § 439, at 542 (1959); Marsh, supra note 41, at 43.
216. See Marsh, supra note 41, at 43.
217. See Phillips, supra note 100, at 188; see also 3 W. FLETCHER, supra note 19, § 931 (describing "substantive fairness" as the "majority" rule).
218. As one court observed, the trend toward deference "is more in keeping with the needs and practices of modern business life." American Timber & Trading Co. v. Niedermeyer, 276 Or. 1135, 1146 n.7, 558 P.2d 1211, 1218 n.7 (1976).
219. See Tent. Draft No. 5, supra note 39, § 5.02(b), at 25-26. Although some courts have indicated that the party seeking to avoid a challenged transaction has to prove its unfairness, most courts have placed the burden of showing fairness on defendants once plaintiffs have shown a debilitating interest. See, e.g., Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921); Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp., 173 F.2d 416 (D.C. Cir. 1949); Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976). But cf. Durfee v. Durfee & Canning, Inc., 323 Mass. 187, 204, 80 N.E.2d 522, 532 (1948) (placing the burden on the plaintiff to show the amount of profits a director made from taking a corporate opportunity). The allocation of the burden of proof, aside from getting plaintiffs past preliminary motions to dismiss, seems more attitudinal than outcome determinative because the allocation will not affect each party's proof at trial. Some
ested transaction replicates an arm's-length market transaction by falling into a range of reasonableness. Second, the transaction must have been of particular value to the corporation, as judged by the scope of the corporation's business. Still an open issue is whether a transaction falling within a range of reasonableness but in which the corporation might have done better through more avid negotiation should be considered fair. Some significant vestiges of validation remain. Although the articulated standard does not depend on a showing of disinterested validation, the method by which a board approves a transaction is still relevant. Courts have invalidated self-dealing, even on fair terms, because of inadequate disclosure or fraud in connection with its approval. Some courts have nonetheless argued that in a close case—when a transaction seems neither "fair" nor "unfair"—the allocation of burden of proof will be determinative. See Bulbulia & Pinto, supra note 201, at 225-26.

220. See Mills v. Electric Auto-Lite Co., 552 F.2d 1239, 1248-49 (7th Cir.), cert. denied, 434 U.S. 922 (1977); Marcy v. Guanajuano Dev. Co., 228 F. 150, 156 (D.N.J. 1915); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298-301, 93 A.2d 107, 110-11 (1952); Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 283, 166 N.E.2d 793, 801-02 (1960); Chelrob, Inc. v. Barrett, 293 N.Y. 442, 452-58, 57 N.E.2d 825, 830-32 (1944); Everett v. Phillips, 288 N.Y. 227, 228, 43 N.E.2d 18, 22 (1942); 3 W. Fletcher, supra note 19, § 919, at 505-12; Note, supra note 195, at 340. Professor Brudney has argued that fairness is vague and lacks an operational theory. He illustrates his point by the range of values for shares of stock in a "simple case" of self-dealing in which majority shareholders purchased corporate assets. The litigants argued for values ranging from $225 to $3200; the trial judge chose $2335; and the appellate court cut that to $1350. See Brudney, supra note 14, at 1434 n.81 (referring to Lebold v. Inland Steel Co., 136 F.2d 876 (7th Cir.), cert. denied, 320 U.S. 787 (1943)).

221. See Marsh, supra note 41, at 49-50. Also left open is how self-dealing gains should be shared. See R. Clark, supra note 33, § 5.2, at 173-74. This question arises particularly in parent-subsidiary dealings, toward which courts have generally taken a deferential approach. Compare Case v. New York Cent. R.R. Co., 15 N.Y.2d 150, 157, 204 N.E.2d 643, 647, 256 N.Y.S.2d 607, 612 (1965) (holding that tax savings parent obtained by filing a consolidated tax return with subsidiary need not be fully shared with subsidiary when "there was no loss or disadvantage" to the subsidiary) with Alliegro v. Pan Am. Bank, 136 So. 2d 656, 668-59 (Fla. Dist. Ct. App.) (requiring consolidated tax savings to be returned to partially owned subsidiary), cert. denied, 149 So. 2d 45 (Fla. 1963). The Delaware courts, for example, have adopted the view that a partially owned subsidiary's dividend policy will not be scrutinized "absent fraud or gross overreaching." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721-22 (Del. 1971).

222. See Tent. Draft No. 5, supra note 39, § 5.02(a)(2)(A) comment, at 34-35; Marsh, supra note 41, at 43.

223. See Tent. Draft No. 5, supra note 39, § 5.02 reporter's note 5, at 49; Wadmond, supra note 191, at 54; see also Melgard v. Moscow Idaho Seed Co., 73 Idaho 265, 273, 251 P.2d 546, 551 (1952) (assuming an absence of full disclosure when such disclosure would have jeopardized the agent's personal interests); Durfee, 323 Mass. at 202-03, 80 N.E.2d at 531 (finding insufficient disclosure of markup in self-dealing supply contract); Wendt v. Fisher, 243 N.Y. 439, 443, 154 N.E. 303, 304 (1926) (invalidating a transaction because of the lack of full disclosure and refusing to look at the fairness of the transaction); Lutherland, Inc. v. Dahlen, 357 Pa. 143, 152, 53 A.2d 143, 148 (1947) (ordering the cancellation of a transaction after finding that no "full and frank disclosure" was ever made); cf. Johnston v. Greene, 35 Del. Ch. 479, 493, 121 A.2d 919, 927 (1956) (upholding a transaction negotiated by an interested director as "fair and free of any overheating or inequitable conduct"). The disclosure requirement has arisen primarily in corporate opportunity cases. See, e.g., Production Mach. Co. v. Howe, 327 Mass. 372, 377-78, 99 N.E.2d 32, 36 (1951) (requiring discl-
have required full disclosure,\textsuperscript{224} while others have said that disclosure is a factor bearing on a transaction's fairness.\textsuperscript{225} Others have expanded the fraud concept to include procedural abuse by an interested director that "practically amounts to fraud."\textsuperscript{226} Thus, in applying the fairness test, courts have taken into account the process by which the transaction was initiated, negotiated, and approved, and have treated disinterested validation with deference.\textsuperscript{227} Some courts and commentators have even suggested that there is a presumption of fairness if a disinterested board approved the self-dealing.\textsuperscript{228}

The abandonment of the formal requirement of disinterested validation may be explained at a number of levels. Approval by disinterested directors—using cleansed procedures to minimize the appearance of interested influence—may be at best a weak measure of whether shareholder wealth is maximized.\textsuperscript{229} Disinterested directors will rarely disapprove an unfair transaction or materially improve a fair transaction just because the board's deliberations are in some sense "adequate." Instead, disinterested approval more likely creates little more than a trap for the unwary and an invitation to subterfuge for the well-advised. Disinterested directors will have few incentives but to defer to interested initiatives.\textsuperscript{230} Further, the requirement would embroil courts in evaluat-


\textsuperscript{225} See Tent. Draft No. 5, supra note 39, § 5.02 comment a, at 27. Some cases have indicated that an interested director or executive need not disclose his profit from a transaction. See id. § 5.02 reporter's note 5, at 54.


\textsuperscript{227} See Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971); Meiselman v. Eberstadt, 39 Del. Ch. 563, 568, 170 A.2d 720, 723 (1961); Beard v. Elster, 39 Del. Ch. 153, 164-65, 160 A.2d 731, 738 (1960); 3 W. Fletcher, supra note 19, § 919, at 509-12; see also Small, supra note 91, at 1356-57 (arguing that the lack of disinterested approval makes a fairness showing harder).


\textsuperscript{229} Little empirical evidence suggests that reliance on disinterested validation, especially when other legal constraints are minimal, helps maximize shareholder wealth. See L. Solomon, O. Schwartz & J. Bauman, Corporations Law and Policy 1355-56 (1982) (arguing that restructuring a board to include corporate-oriented outside directors may hinder the board's monitoring and checking functions and that restructuring to include noncorporate-oriented directors may disrupt board).

\textsuperscript{230} A board's judgment is likely to be the judgment of management, even when conflicts of
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...ing the adequacy of boardroom deliberations—a corporate due process inquiry for which judges are ill-equipped. Nonetheless, the not insignificant procedural inquiry that accompanies fairness review may indicate a judicial reluctance to discard potentially useful clues about a decision's wealth-maximizing attributes.

3. Current Loyalty Review: At a Crossroads.—Loyalty review is today at a critical juncture. Two movements seek to pull the articulated loyalty regime in opposite directions away from an exclusive fairness standard. One movement—Delaware's "entire fairness" standard adopted in Weinberger v. UOP, Inc.—by its terms returns to a concurrent "validation plus fairness" standard. The other movement, found in the ALI Principles of Corporate Governance and in proposals to amend the Revised Model Business Corporation Act (RMBCA), is toward a disjunctive standard of either disinterested validation or fairness. This standard would significantly dilute judicial review.

Legislative guidance on the question of the normative significance...
that courts should give disinterested validation has been inconclusive. The nonvoidability statutes only pose the question. Most courts addressing the issue have interpreted the statutes as simply providing a method of avoiding the automatic voidability rule, without changing the requirement that an interested transaction be fair. But at least one jurisdiction formerly interpreted a nonvoidability statute as requiring both disinterested validation and fairness. And at least one court has interpreted such a statute to mean that disinterested validation is sufficient, regardless of fairness. Recent statutory amendments relaxing quorum requirements for disinterested validation may support this interpretation. The discord reveals the judicial ambivalence toward disinterested validation.

(a) A concurrent requirement of fair dealing.—Weinberger and its progeny reveal the parameters of Delaware's concurrent fair price and fair dealing standard. What emerges is a tacit acknowledgment that the process of board deliberation is a useful guide for evaluating the terms of a transaction, but little more. Although the process cannot be flouted,
the Delaware courts have attached little normative significance to board negotiations and deliberations. At most, informed and diligent internal decision making is a significant aspect of, but neither necessary nor sufficient for, self-dealing validity. The only aspect of the process that rises to a necessary condition is full disclosure to shareholders when the board seeks their approval.242 On the other hand, fairness of a transaction's terms and particularly its price, is necessary and, unless internal procedures were flouted or shareholder disclosure was inadequate, appears to be sufficient. Since the Delaware Supreme Court articulated its "entire fairness" approach in Weinberger, no Delaware court has invalidated a transaction without concluding that some aspect of its terms was unfair or that disclosure to shareholders was inadequate.243

In Weinberger, the court considered a challenge by a subsidiary's minority shareholders of a cash-out merger initiated by its majority parent.244 The court explained "entire fairness" as entailing a two-pronged analysis of both the fairness of the transaction's price and the process of

242. See Kahn v. United States Sugar Corp., No. 7313 (Del. Ch. Dec. 10, 1985) (WESTLAW, De-es database) (assessing damages because of representations creating a misimpression that an independent investment banker had evaluated an offering price); Joseph v. Shell Oil Co., 482 A.2d 335, 342 (Del. Ch. 1984) (granting an injunction to minority shareholders against the majority's tender offer for failing to disclose fully its valuation methodology); see also Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. Ch. 1977) (finding a breach of fiduciary duty for failure to disclose a valuation of corporate assets and emphasizing that "[c]ompleteness, not adequacy, is both the norm and the mandate" of the disclosure requirement).

243. See Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 842, 846 (Del. 1987) (holding that shareholders who had tendered shares into a merger cannot challenge the price, only the adequacy of disclosure); Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1059, 1106-07 (Del. 1983) (finding the timing of a merger unfair); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) (holding that a merger passed the "entire fairness" test when the price paid for the shares was fair and when the surviving corporation dealt fairly with the merging corporation and disclosed all pertinent information); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (concluding that a merger did not meet the fairness standard when the defendants failed to disclose to the shareholders that the share price was at the low end of a reasonable range); Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1334 (Del. Ch. 1987) (preliminarily enjoining a short-form merger because the book value valuation was not shown to be fair, the parent manipulated the timing to prevent valuation, and neither the independent board nor shareholders approved it); Jedwab v. MGM Grand Hotels, 509 A.2d 584, 596-600 (Del. Ch. 1986) (finding that offering a lower price for preferred than for common stock in a merger was not unfair, even though an independent board committee had not made the apportionment between preferred and common). Moreover, in a liquidation proceeding challenging the validity of self-dealing loans, the Delaware Supreme Court concluded that the substantive fairness of the loans (which were on terms comparable to other arm's-length loans to the company and whose proceeds were used to fund the business) was dispositive and held that "fair dealing" was not applicable to that aspect of the case. Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987).

244. Weinberger, 457 A.2d at 703. In addition to enunciating an entire fairness standard, the court also rejected Delaware's short-lived "business purpose" requirement for squeeze-out mergers. See Singer v. Magnavox, 380 A.2d 969, 978-80 (Del. 1977). That requirement attempted to protect minority shareholders by applying a special fairness standard to squeeze-out mergers. It proved readily manipulable and provided no additional meaningful protection, catching only the unwary who had failed to create a proper record of legitimate business purposes. See Weinberger, 457 A.2d at 717. Nonetheless, some courts in other jurisdictions have retained the requirement. See Coggins v. New England Patriots Football Club, 397 Mass. 525, 534-35, 492 N.E.2d 1112, 1116-17 (1986);
its approval. The court characterized fair price as the "preponderant consideration,"245 describing it as relating "to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."246 The fair dealing element, it explained, "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."247 The court invalidated the merger in question because a feasibility study prepared by two of the subsidiary's management directors (who were also directors of the parent) had not been disclosed to the subsidiary's outside directors or shareholders.248 The study revealed that the twenty-one dollar merger price was at best on the low end of a twenty-one to twenty-four dollar range that the parent considered acceptable. On remand, remedial damages were based not on what the outside directors might have done had they known of the study but rather on what the shareholders might have done had they known.249 The price unfairness and the absence of shareholder disclosure, in the end, was critical.

Rosenblatt v. Getty Oil Co.250 illustrates that the internal decision-making process may serve as a guide for court review but has no real teeth. In Rosenblatt, the court upheld as entirely fair a squeeze-out merger in which the subsidiary's minority shareholders received stock in the parent corporation.251 The court enthusiastically found fair dealing: the board disclosed internal valuations of the subsidiary's assets, as well as an outside opinion on the fairness of the merger; a team of outside directors, whose negotiations with the parent's team "clearly were adversarial," represented the minority shareholders;252 the directors met frequently and reviewed many documents; and the minority shareholders overwhelmingly approved the merger.253 The cleanliness of the process

245. Weinberger, 457 A.2d at 711.
246. Id.
247. Id.
248. See id.
250. 493 A.2d 929 (Del. 1985).
251. Id. at 940.
252. Id. at 941.
253. Id. at 936; see also In re Maxxam Group, Inc., Stockholders Litig., No. Civ. A. 8636 (Del. Ch. Apr. 16, 1987) (WESTLAW, De-cs database) (upholding a merger of sister subsidiaries when negotiated by independent committees, each advised by an outside investment banker). The Delaware courts have shifted the burden of showing unfairness to plaintiffs when nonmanagement direc-
was not surprising. The parent knew it would be sued when it initiated the merger, and it may have been meticulous to a fault. Nonetheless, the court liked what it saw and refused to invalidate the merger. It did so despite the parent’s failure to disclose an internal valuation its management had prepared, the only aspect of the process that could not be manipulated. The court distinguished the undisclosed management valuation from the critical Weinberger internal study on the grounds that the subsidiary’s directors had not prepared the Rosenblatt study or used its information and that in any event the merger terms were fair. In the end, the court concluded that the asset valuations that underlay the merger price, which the minority shareholders did not challenge on appeal, supported the fairness of the price.

Rabkin v. Philip A. Hunt Chemical Corp. also makes clear that the terms of the merger, not the process, are dispositive. In Rabkin the court held that shareholders stated a cause of action when they challenged a back-end freeze-out merger on the grounds that it was unfairly timed to occur immediately after a contractual equal treatment requirement had expired. The requirement, which the company’s controlling shareholder had negotiated when he sold his control bloc compelled the acquiring company to pay minority shareholders in any back-end merger the same price for their stock that the acquiror had paid the controlling shareholder for his. The requirement expired one year after the acquisition. In deciding the case, the court in effect returned to a business purpose analysis—the timing of the back-end merger exposed the parent’s purpose to advance its interests at the expense of the minority shareholders. Although the court characterized the case as one of fair dealing (because the Weinberger court had designated the timing and structure of a transaction as aspects of fair dealing), the real challenge
was to the terms of the transaction and not any internal deliberative process. Reversing the Chancery Court, which had left the minority shareholders to an appraisal remedy because it viewed price as the "preponderant consideration" and because the minority made no allegations of deception, the Supreme Court concluded that the timing raised substantial questions about the fairness of the price. Both courts treated the process of decision making as irrelevant.

The actual approach of Weinberger and its progeny, though perhaps not their articulated standards, has much to recommend it. A transaction's terms, along with disclosure to shareholders, remain paramount. This approach does not discount entirely the possibility that diligent internal processes will produce substance, though the requirement of adhering to decision-making niceties seems largely hortatory. The approach provides a useful measure of whether conflicting interests motivated the transaction. It is an approach that, with substantive modifications, provides a useful model for measuring directorial independence.

(b) Assuming the sufficiency of disinterested validation.—Proposals to revamp loyalty review to give conclusive normative significance to disinterested validation would largely remove scrutiny of self-dealing transactions from the courts and place it in the hands of disinterested directors. Although scattered cases provide some conclusory support for such an approach, it is mostly the product of recent efforts by those writing the ALI Principles of Corporate Governance and the proposed revisions of the RMBCA. Although one may view the development cyni-

260. The fair dealing requirement is in this sense also a requirement concerning the terms, not just the process, of the merger. "[T]he ultimate question is whether the terms of the transaction itself are entirely or intrinsically fair." Jedwab v. MGM Grand Hotels, 509 A.2d 584, 599-600 (Del. Ch. 1986).
262. Rabkin, 498 A.2d at 1105-06.
263. See Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971) (reviewing a corporate purchase of six companies from family owning 44% of corporation's stock under business judgment rule, rather than fairness standard, because the plaintiff failed to show that the family dominated the outside directors who had approved the purchases); Gries Sports Enters. v. Cleveland Browns Football Co., No. 49184 (Ohio Ct. App. Apr. 25, 1985) (WESTLAW, Oh-cs database) (applying Delaware's business judgment rule and upholding majority shareholder's self-dealing transaction that had been approved by a majority of "disinterested" directors, namely the corporation's outside counsel and an employee), rev'd, 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986); cf. Ong Hing v. Arizona Harness Raceway, 10 Ariz. App. 380, 384-85, 459 P.2d 107, 111-12 (1969) (discussing prior case law indicating that resolutions regarding directors' employment and salary must be approved by "an independent and unbiased majority of the directorate" regardless of fairness, though eventually applying fairness test); Abeles v. Adams Eng'g Co., 35 N.J. 411, 428, 173 A.2d 246, 255 (1961) (rejecting the argument that when the certificate of incorporation specifically allows transactions between corporations with common directors there is no need to look into the transaction's fairness).
cally as another in a series of concessions to management prerogative, a more charitable explanation may be that the ALI and RMBCA drafters have felt compelled to deal indirectly with the mixed-motive vacuum by loosening the standards that apply to loyalty review. To the extent that courts may be persuaded to apply loyalty review to decisions in which management is inherently interested, more deferential standards lessen the possibility that courts will upset beneficial mixed-motive transactions.

This indirect approach to intermediate review, however, is flawed in several respects. First, it unnecessarily extends deferential review to loyalty cases. Second, it emphasizes procedural review without adequate assurances that the indirect approach validly measures a decision's wealth-maximizing attributes. Third, it perpetuates the care-loyalty subterfuge by not explicitly recognizing intermediate review.

(i) The ALI’s duty of fair dealing.—The ALI Principles embraces disinterested validation as a measure of “fairness,” and, in fact, the ALI reporters propose to rename the “duty of loyalty” as the “obligation of fair dealing.” Under the ALI Principles, which adopts the structure of the nonvoidability statutes, a self-dealing transaction survives loyalty review if, after disclosure, either (1) informed, disinterested directors or shareholders approve the transaction or (2) a court determines it to be fair.

Disinterested director approval is subject to review under a new, weakened fairness standard that gives “substantial deference to the judgment of disinterested directors.” An interested trans-

265. Tent Draft No. 5, supra note 39, § 5.02(a)(2)(B).
266. See id. § 5.01 comment, at 23.
267. The ALI Principles states:

A director or senior executive who enters into a transaction with the corporation (other than a transaction involving the payment of compensation) fulfills his duty of loyalty to the corporation with respect to the transaction if:

(1) disclosure of the conflict of interest and the transaction is made to the corporate decision-maker who authorizes or ratifies the transaction; and

(2) (A) the transaction is fair to the corporation when entered into; or

(B) the transaction is authorized, following such disclosure, by disinterested directors, and could reasonably be believed to be fair to the corporation at the time of such authorization; or

(C) the transaction is authorized or ratified, following such disclosure, by disinterested shareholders, and does not constitute a waste of corporate assets at the time of the shareholder action.

See id. § 5.02(b). The challenging party has the burden of proof in the case of disinterested validation; the self-dealing director or executive has the burden if the fairness standard applies. Id. § 5.02(b). Deference to disinterested decisions seems to run one way. Disinterested approval makes a transaction valid, but disinterested disapproval apparently does not render a transaction invalid, assuming it passes a fairness review. See id. § 5.02(a).
268. Id. § 5.02(a)(2)(B) comment, at 36.
action approved by disinterested directors passes loyalty muster if it "could reasonably be believed to be fair to the corporation."\(^\text{269}\) A court may rescind a transaction that fails this standard,\(^\text{270}\) but it cannot hold disinterested directors who approved the transaction liable unless they breached their duty of care.\(^\text{271}\)

Procedural review under the *ALI Principles* survives in two forms. First, the *ALI Principles* requires disclosure of interest to the validators,\(^\text{272}\) and the sufficiency of disclosure apparently would be open to court review. Second, the *ALI Principles* assumes judicial flexibility to consider the "objectivity" of disinterested directors, paying particular attention to such things as whether a director's receipt of fees "impairs his objectivity," whether the director "sought the assistance of independent advice," and whether the director "followed procedures designed to enhance...objectivity."\(^\text{273}\) These objectivity standards and the reasonable belief standard seek to provide an eclectic measure of independence.

The drafters of the *ALI Principles* do not attempt to justify this significant dilution of loyalty review, except to point out that the committee structure in public corporations (along with, presumably, boards composed significantly of outside directors) "is designed to provide a general board environment conducive to objective decisionmaking."\(^\text{274}\)

(ii) The *RMBCA* safe harbor.—The proposed new subchapter F of the *RMBCA* adopts the same kind of safe harbor as the *ALI Principles*. Under the proposal, an interested transaction cannot be set aside if it is (1) disclosed (unless disclosure would breach a confidence) and approved by a majority of disinterested directors; or (2) disclosed and approved by a majority of disinterested shareholders; or (3) shown to be fair to the corporation, whether or not disclosed.\(^\text{275}\) Approval by dis-

269. *Id.* § 5.02(a)(2)(B). The *ALI Principles* illustrates the operation of this standard with a hypothetical case in which a director sells property to a corporation for $7.5 million. The property "might conceivably be worth $7.5 million," but no buyer had been "willing to pay more than $5 million" when the director had offered the property for sale and listed it with a broker. The sale, approved by disinterested directors for $7.5 million, would fail loyalty review, because it "could not reasonably be regarded as fair." *Id.* § 5.02 illustration 6, at 37-38. One judge has used this test to justify a controlling shareholder's sale of property to a corporation for consideration totalling $6 million, even though the property had been valued at $5.2 to $5.9 million. See *Gries Sports Enters. v. Cleveland Browns Football Co.*, 26 Ohio St. 3d 15, 34, 496 N.E.2d 959, 974 (1986) (Holmes, J., dissenting).


271. *See id.* introductory note a, at 15.

272. The *ALI Principles* requires disclosure because either the validators might refuse to approve an interested transaction at less than an optimum price, *id.* introductory note d, at 19, or they might insist upon negotiating a better one, *id.* § 5.02(a)(1) comment, at 30-31.

273. *Id.* introductory note c, at 17.

274. *Id.*

275. REVISED MODEL BUSINESS CORP. ACT subchapter F, §§ 8.61-.63 (Proposed Official Draft
interested directors would, it appears, be subject to care review. The stated purposes of the safe harbor approach are "to increase predictability and to enhance practical administrability." The drafters justify the proposal by explaining that "an interest conflict is not in itself a tort or a crime or injurious to others. In many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest. And men do not always act selfishly."  

4. Conclusion: Distrust of Deferring to Disinterested Validation.—The history of loyalty review offers two lessons for fashioning an independence regime. First, it reveals recurring, fundamental doubts that disinterested directors can or will be independent of interested influence. At each stage of the regime's development—from a flat prohibition on self-dealing, to a requirement of disinterested validation, to a requirement of substantive fairness, to the sufficiency of disinterested validation—the loyalty standards have assumed the improbability of complete independence. No doubt the distrust has arisen in part because of what deferring to disinterested validation under the dichotomous model would mean: subjecting validation to care review would effectively mean no review at all. The absence of a middle ground goes far in explaining the current (though tenuous) majority rule requiring substantive fairness.

Second, the history reveals doubts about whether process can be a valid measure of a corporate decision's value. These doubts are reflected in the current majority fairness standard and in Delaware's recent emphasis on substantive review.

Nonetheless, as demonstrated by the Weinberger "fair dealing" standard and the current proposals to make disinterested validation sufficient, many harbor a hope that internal mechanisms can supplement and substitute for judicial intervention. The ALI proposal fashions a middle ground in nonunique interested contexts as a reaction, if not an attempted solution, to the absence of a general theory of independence. But the ALI proposal, and certainly the RMBCA proposal, go too far. There has been insufficient experience with, and certainly insufficient analysis of, a regime of independence to conclude that intermediate standards should be extended to nonunique, interested contexts. The fiduciary model should be moved more slowly.

277. Id. at 693.
III. Adapting the Fiduciary Model: Takeover Defenses

The most prominent (and fertile) mixed-motive context—corporate responses in takeover fights—illustrates both the inadequacy of the traditional fiduciary model and, at the same time, the development of standards of independence. Defensive tactics in takeover battles simultaneously raise obvious and inherent conflicts of interest and offer shareholders unique possibilities for collective representation by the board. The risk of management entrenchment is nowhere clearer. Yet management and the board are also in a unique position to use corporate assets and the governance machinery to drive away inadequate or coercive bids, to induce better bids, to find alternate bids, and to offer shareholders internally generated value through stock repurchases and restructurings. Each of these responses could potentially maximize the value of shareholders’ equity and voting control.

At the heart of this inherent tension are outside directors who purportedly act as independent representatives of shareholders. The evolution of standards governing their actions, an evolution that has not wanted for judicial experimentation or academic dissection, provides an instructive picture of the emergence of a regime of independence.

The takeover context, however, is not the only mixed-motive context for which courts (and to an extent legislatures) have crafted explicit adaptive standards. In a variety of others, each characterized by inherent conflicts of interest and the potential for uniquely valuable corporate benefits, the traditional fiduciary model does not supply the rules. Examples include executive compensation,278 transactions between investment companies and their investment advisors (regulated under the Investment Company Act of 1940),279 dismissal of shareholder litigation,280 and transactions involving corporate opportunities.281 As in the control context, adaptations in these areas center on the validating role of disinterested directors.282

I next consider the evolution of a duty of independence in the takeover context.

A. The Dynamics of Interest in Takeover Fights

Any takeover fight raises “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corpora-

281. See Johnston v. Greene, 121 A.2d 919, 927 (Del. 1956).
tion and its shareholders.283 Any unsolicited or nonnegotiated proposal to change corporate control, whether through the proxy mechanism or the purchase of equity control, is likely to be premised on the inadequacy of the performance of the incumbent board and management.284 Management, which faces losing the significant emoluments of control, has a rational and ineluctable motive to use the governance machinery to perpetuate control. Only an irrational manager, or one facing significant countervailing incentives, would accede to the change without trying to avoid or soften the blow. For outside nonmanagement directors, the pressures to resist takeover attempts are remarkably similar. Outside directors face losing their positions of “power, prestige and prominence,” not to mention their increasingly handsome directors’ fees and perquisites;285 they face the embarrassment of losing a fight;286 and they face breaking their tacit promise of fealty to management.287 In general, their incentives are closely aligned with those of management. Moreover, some outside directors, such as outside lawyers and investment bankers, also may lose financially significant affiliations with the company.288

The variety of defensive strategies that boards and managers (and their financial and legal counsel) have devised attests to the perceived gravity of the threat. The board can choose from a potent arsenal and a colorful argot.289 It can: (1) revise the corporate governance structure

286. See CTS Corp., 794 F.2d at 258-59.
289. There are other lists of these epithets and discussions of their operation. See SEC ADVISORY COMMITTEE REPORT ON TENDER OFFERS, REPORT OF RECOMMENDATIONS app. 3, at 140-
by instituting staggered board or supermajority provisions—thus making any attempt to change control more drawn out and expensive;\(^2\) change the capital structure through issuer self-tenders, market sweeps, poison pills, recapitalizations, fair-price amendments, or stock lockups—thus making the company less financially attractive;\(^3\) alter the shareholder mix through issuer self-tenders, stock contributions to employee benefit plans, or stock lockups—thus increasing the proportion of shareholders sympathetic to (or controlled by) management;\(^4\) acquire new parts or sell existing parts of the company’s business through asset lockups, crown jewel sales, scorched earth policies, antitrust blocking acquisitions, or banking acquisitions—thus making the company less attractive from a business or regulatory standpoint;\(^5\) prefer a more palatable bidder using white knight mergers, management buyouts, or no-shop clauses—thus increasing the likelihood management will be retained;\(^6\) accelerate or increase management’s employment benefits


\(^6\) See, e.g., Hanson Trust, 781 F.2d at 274 (management buyout); Mobil, 669 F.2d at 376 (white knight merger); Revlon, 506 A.2d at 176, 184 (management leveraged buyout and no-shop clause). See generally Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduci-
through golden parachutes or contingent vesting of pension and stock option plans—thus increasing the costs of a takeover and softening the blow if one nevertheless takes place;\(^7\) buy out the bidder using greenmail—thus ending the threat;\(^8\) attack the bidder through "Pac-man" defenses and antitrust, securities disclosure, or margin litigation—thus raising its costs.\(^9\)

Shareholder wealth maximization would seem to compel the prohibition of these defensive tactics, or at least strict scrutiny of them under a loyalty-type review.\(^{298}\) Some commentators have argued for fiduciary rules compelling management passivity.\(^{299}\) A hostile takeover, after all, may be powerful evidence that internal governance, market, and fiduciary constraints have failed to maximize shareholder wealth. And defensive tactics, which necessarily limit shareholders' investment autonomy, are hardly the kinds of decisions presumptively entrusted to central man-

\(^{295}\) See, e.g., Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 265 (2d Cir. 1984) (stock to employee stock option plan); see also Bress, Golden Parachutes: Untangling the Ripcords, 39 STAN. L. REV. 955, 962 (1987) (noting that the legal status of golden parachutes is not clear, but that most commentators believe they will be upheld under the business judgment rule); Riger, On Golden Parachutes—Ripcords or Ripoffs? Some Comments on Special Termination Agreements, 3 PACE L. REV. 15, 31-33 (1982) (criticizing special termination agreements as methods for deterring takeovers).


\(^{298}\) A traditional fairness review would be pointless, because defensive tactics by their nature have no open market counterpart against which they can be measured. See Gilson, supra note 68, at 826-27 (citing M. EISENBERG, THE STRUCTURE OF THE CORPORATION 34 (1976) (citing Smith v. Good Music Station, 36 Del. Ch. 262, 129 A.2d 242 (1957))). Nonetheless, an inquiry into whether entrenchment motives played any role in the decision to pursue the tactic could be useful. Such an inquiry could conceivably serve as a measure of whether shareholders were forced to pay a management entrenchment premium.

management. Moreover, condoning takeover defenses may reduce incentives for directors to monitor management diversion or slackness and decrease the number of bids in the market for corporate control.

But defensive tactics may also have significant wealth-producing effects. Empirical studies, supported by anecdotal evidence of higher bids spurred by defensive tactics, indicate that measured defensive tactics may improve shareholder wealth by providing dispersed shareholders with an alternative bidder (a white knight or management group) or a collective negotiator (the board). One can make a strong argument that mandating management passivity, even if it eases restraints on the market for corporate control and imposes greater management discipline, may be more costly than allowing bargaining by the target. Directors are in a unique position to fashion defensive tactics that maximize shareholder wealth—a possibility unavailable in any other form (aside

300. See Panter, 646 F.2d at 299-300 (7th Cir. 1981) (Cudahy, J., concurring in part, dissenting in part) (distinguishing between business and “corporation-shareholder” relationships (citing Note, Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations, 58 COLUM. L. REV. 1030, 1066 (1958)).

301. See, e.g., Herzl, Schmidt & Davis, Why Corporate Directors Have a Right To Resist Tender Offers, 3 CORP. L. REV. 107, 109-10 (1980) (noting that competition among possible acquirors will benefit target shareholders); Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?, 28 J.L. & ECON. 151, 165-72 (1985) (contending that targets which resist tender offers but which are later acquired perform better than targets that do not resist, while those that resist successfully perform more poorly); Lipton, Takeover Bids in the Target’s Boardroom, 35 BUS. LAW. 101, 106 (1979) (“Contrary to popular belief shareholders usually win when a takeover is rejected.”); Oesterle, Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 CORNELL L. REV. 53, 72 (1985) (noting that intervention of target management often increases shareholders’ gain).


303. See, e.g., Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 268-70 (2d Cir. 1986) (describing takeover battle in which hostile bidder raised its offer from $60 to $72 in response to defensive tactics).

304. See Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 254 (7th Cir. 1986) (Posner, J.) (interpreting Delaware law to allow “management to create a process that will maximize the value of [passive investors'] shares in a takeover situation”); Bebchuk, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028, 1041-46 (1982) (arguing that the rule of auctioneering increases the shareholders' premium in negotiated acquisitions because it strengthens the board's bargaining position and serves as a check on self-serving management); Oesterle, supra note 301, at 64-70 (discussing methods of empowering managers to be negotiating agents).

305. See Haddock, Macey & McChesney, Property Rights in Assets and Resistance to Tender Offers, 73 VA. L. REV. 701, 719-26 (1987) (suggesting that reversible stalling tactics, such as purchasing a third company that is a competitor of the bidder, allow target management time to search for alternate bidders and to negotiate the best price with initial bidder).
from administrative or regulatory intervention) to widely dispersed shareholders. It is not surprising that shareholders, even discounting shareholder passivity, have generally endorsed antitakeover devices.\textsuperscript{306} At least one advocate of greater judicial intervention has acknowledged that fairness review of defensive tactics may be inappropriate.\textsuperscript{307}

B. Adaptations in the Takeover Context

Cases in the control context—principally, cases reviewing defensive tactics—illustrate powerfully the inadequacy of the traditional model’s care and loyalty regimes. Analysis under the traditional loyalty regime leads to an insoluble paradox. The nature of the control context creates an inherent potential for management to use corporate assets or the governance machinery to perpetuate their own control of the corporation rather than to ensure that shareholders get the best available deal. The traditional loyalty standards would therefore require a court to measure any control transaction against a hypothetical arm’s-length transaction—that is, one in which entrenchment motives are absent—to determine the transaction’s fairness. But this test is paradoxical. The court is forced to compare the challenged transaction to a hypothetical transaction that, because of the nature of the control context, cannot exist.\textsuperscript{308} It borders on the absurd to talk about what a poison pill rights plan, what a staggered board, or what a debt-for-equity restructuring would have looked like if control implications were absent. At best there may be some transactions, such as stock redemptions and scorched earth policies, that have noncontrol analogues against which crude comparisons can be made. But generally, the traditional loyalty regime and fairness review fail.

The traditional care regime does no better and in fact may do worse. It ignores the potential for entrenchment motives inherent in the control context, assuming that it is like any other enterprise context. This assumption is a fiction. The traditional care regime and the business judgment rule would provide a near-absolute shield for management entrenchment despite the inherent conflict present in corporate control battles.

\textsuperscript{307} See Gilson, supra note 68, at 824.
\textsuperscript{308} See id. at 826-27 (citing M. Eisenberg, The Structure of the Corporation 34 (1976) (citing Smith v. Good Music Station, 36 Del. Ch. 262, 129 A.2d 242 (1957))).
1. The Early Approach: Skewing the Traditional Model.—Courts quickly recognized the inappropriateness of either traditional approach, though their solution in essence turned a blind eye to the possibility of entrenchment. Under the chosen approach, courts prohibited transactions for which they found that entrenchment was a primary or dominant purpose, usually without a further inquiry into fairness. Otherwise, the inquiry shifted to the care regime and the business judgment rule. Defendants could show the absence of a dominant entrenchment motive by demonstrating that the transaction was in response to a threat to the corporation’s business and that they had conducted a “reasonable investigation” into the threat before responding. Thus, the courts’ focus on process provided flexibility to avoid the mixed-motive trap.

The reasonable investigation standard, which came to be described as an extension of the business judgment rule, produced remarkably uniform results. Rarely did a court find a dominant entrenchment motive, and due care review unfailingly exposed a reasonable investigation stating that the desire to retain control had to be the “sole or primary motive” for a challenged decision by directors rather than simply “a” motive; Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971) (nullifying the date of a shareholders’ meeting upon a showing that management advanced the date specifically to prevent insurgent shareholders from waging a proxy contest); Cheff v. Mathes, 41 Del. Ch. 508, 504, 199 A.2d 556, 554 (1964) (allowing a buyout of a potential acquirer because the acquirer would injure the company’s business); Bennett v. Propp, 41 Del. Ch. 14, 20, 187 A.2d 405, 408 (1962) (disallowing chairman’s stock purchase because its purpose was to enable him to stay in control); Yasik v. Wachtel, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (1941) (upholding a stock transfer when the challenger could not prove an entrenchment motive). Courts generally said that a showing of a dominant entrenchment motive ends the inquiry, see Cheff, 41 Del. Ch. at 508, 199 A.2d at 556, though some cases suggested that entrenching incumbents may nonetheless absolve themselves by bearing their burden of showing fairness, see Treadway Cos. v. Care Corp., 638 F.2d 357, 381-83 (2d Cir. 1980) (interpreting New Jersey law).

309. See, e.g., Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980) (affirming a jury charge stating that the desire to retain control had to be the “sole or primary motive” for a challenged decision by directors rather than simply “a” motive); Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971) (nullifying the date of a shareholders’ meeting upon a showing that management advanced the date specifically to prevent insurgent shareholders from waging a proxy contest); Cheff v. Mathes, 41 Del. Ch. 508, 504, 199 A.2d 556, 554 (1964) (allowing a buyout of a potential acquirer because the acquirer would injure the company’s business); Bennett v. Propp, 41 Del. Ch. 14, 20, 187 A.2d 405, 408 (1962) (disallowing chairman’s stock purchase because its purpose was to enable him to stay in control); Yasik v. Wachtel, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (1941) (upholding a stock transfer when the challenger could not prove an entrenchment motive). Courts generally said that a showing of a dominant entrenchment motive ends the inquiry, see Cheff, 41 Del. Ch. at 508, 199 A.2d at 556, though some cases suggested that entrenching incumbents may nonetheless absolve themselves by bearing their burden of showing fairness, see Treadway Cos. v. Care Corp., 638 F.2d 357, 381-83 (2d Cir. 1980) (interpreting New Jersey law).

310. See Buffalo Forge Co. v. Ogden Corp., 717 F.2d 775, 779 (2d Cir. 1983); Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980); Treadway, 638 F.2d at 382; Cheff, 41 Del. Ch. at 506, 199 A.2d at 555; see also Brownstein, supra note 185, at 177 (“It is no longer disputed that the business judgment rule is applicable to director conduct in the takeover context”); Lipton, supra note 301, at 124 (“When the directors have made a reasonable good-faith decision to reject the takeover . . . , the business judgment rule should apply equally to any and all defensive tactics.”).

311. See Cheff, 41 Del. Ch. at 506-08, 199 A.2d at 555-56. In Cheff, the court seemed to hold that the burden of showing “reasonable investigation” lay on directors at the outset because of the inherent conflict of interest present in control contests. See id. at 504-05, 199 A.2d at 554. Later courts have placed on plaintiffs the initial burden of showing that directors are interested in the outcome of a control battle. Only then does the burden shift to the directors to justify the transaction. See Panter, 646 F.2d at 297; Treadway, 638 F.2d at 382-83.

312. See Treadway, 638 F.2d at 382-83.

313. Showing an entrenchment motive has proved difficult, and plaintiffs have succeeded in only a few cases. See Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 265 (2d Cir. 1984) (invalidating a precipitous issue of stock to an employee stock option plan because of its entrenchment purpose); Seagrave Corp. v. Mount, 212 F.2d 389, 396-97 (6th Cir. 1954) (holding that a buyout and retention of incumbents "injected into the picture a personal interest"); Bennett, 41 Del. Ch. at 21, 187 A.2d at 1418.
tion supported by a rational business purpose. Management almost without exception won.

Two leading cases—in which the courts essentially accepted perpetuating management incumbency as a rational business purpose—illustrate the early approach's toothlessness. In *Cheff v. Mathes*, minority shareholders challenged the use of corporate funds to buy out a greenmailer who had threatened to take control of the company and change the way it marketed its products. The Delaware Supreme Court reversed a Court of Chancery finding that the buyout's purpose was to perpetuate management's control. The court held that the transaction must be upheld unless entrenchment was its sole or primary motive, a subjective standard markedly different from the objective fairness standard applicable to classic self-dealing. To overcome a charge of improper motive, the board had only to show that the buyout was

408-09 (finding chairman liable for making unauthorized stock repurchases to fend off a potential bidder).

314. See, e.g., Gearhart Indus. v. Smith Int'l, 741 F.2d 707, 720 (5th Cir. 1984) (stating that the burden of proof is on a director to show that a challenged action was fair to the corporation); *Panter*, 646 F.2d at 297 (upholding a challenged action by directors because of a board member's experience in evaluating the soundness of similar legal claims and because the challenged action served a rational business purpose); *Crouse-Hinds*, 634 F.2d at 702 (exonerating directors because of absence of a showing of self-interest or bad faith); *Treadway*, 638 F.2d at 374 (exonerating a director because his actions were not part of a purposive plan to maximize personal profits at the expense of shareholders); *Kaplan v. Goldsamt*, 380 A.2d 555, 568 (Del. Ch. 1977) (finding rational business purpose for a greenmail payment based on advice that the price was fair); *Cheff*, 41 Del. Ch. at 507, 199 A.2d at 555-56 (exonerating directors upon a finding that they reasonably relied on investigations that led to the challenged activity).

315. There are many others. See, e.g., *Gearhart*, 741 F.2d at 724 (upholding springing warrants under the Texas traditional business judgment rule); *Treadway*, 638 F.2d at 383 (exonerating board for a movement toward a business combination because it was not "simply acting to maintain its own control"); *Crouse-Hinds*, 634 F.2d at 704 (upholding directors' support for a negotiated merger that would have resulted in retention of incumbents and rejecting tender officer's contention that the support constituted bad faith); *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980) (stating that "at a minimum the plaintiff must make a showing that the sole or primary motive of the defendant was to retain control"); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 633 (D. Md. 1982) (upholding directors' attempts to maintain control after a merger because the other corporation's management had "little managerial competence or experience"); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) (noting that the business judgment rule gives a board wide discretion within which it can act for the best interests of the corporation); *Abramson v. Nytronics*, 312 F. Supp. 519, 531 (S.D.N.Y. 1970) (upholding shareholders' approval of greenmail paid to maintain "stability in management" and to preserve "employee morale"); *Kors v. Carey*, 39 Del. Ch. 47, 49, 158 A.2d 136, 141 (1960) (upholding greenmail payment, which comprised an amount that was less than a proxy fight would cost, to avoid a threat to customer relations and to the future of the business); *Cummings v. United Artists Theatre Circuit*, 237 Md. 1, 16, 204 A.2d 795, 806 (1964) (approving a stock sale to a friendly party in the face of a proxy battle).


317. "Greenmail" is the corporate cousin of blackmail. Whereas a blackmailer seeks to extort money by threats to destroy a personal reputation, the greenmailer threatens to unseat management unless his demands, usually the redemption of his stock at a premium, are met. See R. HAMILTON, *supra* note 77, § 17.18.1, at 411.

318. *Id.* at 508, 199 A.2d at 553.

319. *Id.* at 508, 199 A.2d at 554.
motivated by a good faith belief, based on a reasonable investigation, that it was necessary "to maintain what the board believed to be proper business practices." Finding that the company's investigation revealed that the greenmailer posed a "threat to the existence of [the corporation] or at least existence in its current form," the court upheld the buyout. The Delaware court's approach seemed clear. Even if directors in the control context are "confronted with a conflict" making "objective decisions . . . difficult," entrenchment purposes (if properly packaged) can survive fiduciary review. Cheff v. Mathes has been correctly read to mean that maintaining corporate "independence," a thinly veiled euphemism for perpetuating management control, is a sufficient business purpose.

The dominant motive test reached its nadir seventeen years later in Panter v. Marshall Field & Co. when the Seventh Circuit applied Delaware law to uphold a directed verdict in favor of Marshall Field's ten-

320. Id.
321. Id. at 508, 199 A.2d at 556. The court also found that the purchase price was reasonable even though it was above market. The court explained that a higher purchase price for the large block of shares reflected a control premium. Id. at 506, 199 A.2d at 555.
322. Id. at 508, 199 A.2d at 556. In Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962), the Delaware Supreme Court made clear that the key to using corporate assets for entrenchment is to conduct deliberations that suggest a nonentrenching purpose. In Bennett, the court held liable the board's chairman, who had made unauthorized stock purchases to block a takeover bid with no prior board investigation to support a nonentrenchment purpose. See id. at 21, 187 A.2d at 409. But the court upheld the board's ratification of the purchases and refused to impose liability on the other directors. See id. at 23-24, 187 A.2d at 410. One director testified that he voted to ratify because he feared that the brokers from whom the chairman had bought the stock would sue the corporation. The other directors did not testify specifically about their fears of broker claims, and the minutes of the board meeting recited "only... the need of repelling [the] supposed threat" of the takeover bid. Id. at 24, 187 A.2d at 410. The court concluded, however, that the threat of an avalanche of broker claims "must have been obvious to all." Id. For planners, the lesson was to involve the board and later concoct a corporate purpose.
323. Cheff, 41 Del. Ch. at 505-06, 199 A.2d at 554 (citing Bennett, 41 Del. Ch. at 22, 187 A.2d at 409).
324. See, e.g., Brudney, Fiduciary Ideology in Transactions Affecting Corporate Control, 65 Mich. L. Rev. 259, 269 (1966) (arguing that under such cases as Cheff, a board's actions to maintain corporate independence can be motivated by mixed purposes, some of which are not connected to retaining control and are thus proper); Gilson, supra note 68, at 827-29 (arguing that the Cheff court was content to validate the disputed transaction based on a showing of director good faith, thereby avoiding any inquiry into the objective fairness of the transaction); Israels, Corporate Purchase of Its Own Shares—Are There New Overtones, 50 Cornell L.Q. 620, 624 (1965) (describing the Cheff court's treatment of the stock purchases as an "ordinary 'business judgment'" standard and noting directors' broad discretion under Cheff to decide that a threatened takeover effort is not in the best interests of shareholders); Note, The Misapplication of the Business Judgment Rule in Contests for Corporate Control, 76 Nw. U.L. Rev. 980, 1001-02 (1982) (noting that the Cheff decision was the first to place a major emphasis on the distinction between inside and outside directors and that Cheff imposes a lighter burden of proof on outside directors on the good faith issue); see also Kors v. Carey, 39 Del. Ch. 47, 55, 158 A.2d 136, 141-42 (1960) (upholding a corporate stock purchase to fend off a hostile bid because the potential acquiror wished to force an injurious business policy upon the corporation).
person board, seven members of which were outside directors. The board had approved a series of acquisitions and an antitrust lawsuit that eventually drove away a takeover bidder, Carter Hawley Hale, which had offered to pay shareholders a premium of nearly seventy-five percent over market.\textsuperscript{326} In considering the claim that management had embarked on an entrenching policy of "independence," the court accepted the board’s explanation that its actions were intended to "build value within the company"\textsuperscript{327} and "to protect the corporation against the perceived damage an illegal merger could cause."\textsuperscript{328} The court rejected the argument that a "compelling business purpose" test applied in the takeover context,\textsuperscript{329} concluded that the acquisitions (which had raised antitrust impediments for Carter Hawley Hale) were "reasonable and natural," and found that in any event the plaintiffs had not shown a sole or primary purpose for entrenchment.\textsuperscript{330}

In a now-classic dissent, Judge Cudahy complained that the majority had shredded the last constraints of fiduciary review in the takeover context. He pointed out that "hostile tender offers unavoidably create a conflict of interest,"\textsuperscript{331} even for outside directors, who are often dominated by management and who face losing their own "positions of power, prestige and prominence (and . . . their not inconsequential perquisites)."\textsuperscript{332} He went on to argue that the case presented a triable issue of whether the board was sufficiently interested to warrant a loyalty review. But the majority turned a deaf ear, and its adherence to the business judgment rule foreclosed any factual inquiry into whether "[o]ne man’s desire to ‘build value’ may be another man’s desire to ‘keep control at all costs.’"\textsuperscript{333}

The initial tendency of courts to embrace the business judgment rule can be explained at a number of levels. In part, it reflected judicial inertia and diffidence toward the high-stakes takeover game. Moreover, the dichotomous fiduciary model provided few tools for finely balancing management accountability and autonomy, especially when shareholder wealth maximization seemed to point in both directions. And not least importantly, corporate takeovers profoundly affect the nation’s economic future, a course that judges might understandably conclude should be set
legislatively and not judicially, using a corporate fiduciary bludgeon.334

In general, commentators have been less sanguine than courts about the wisdom of deferring to management in the corporate control context. They have criticized rules that effectively wrest from shareholders and give to management all significant ownership control. Criticism of the dominant motive analysis and the traditional business judgment rule in the control context is now legion.335 As Professor Brudney has argued, "Whenever a takeover is attempted, the independence and judgment of outside directors are put to their severest tests. In these circumstances, the propriety of the independent directors’ decision to resist a takeover, if not also their own liability, should be least protected by the business judgment rule.”336

To make judicial abstention more palatable, well-advised managers placed approval of defensive tactics in the hands of outside directors—by composing the board with a majority of such directors,337 by having management directors absent themselves when the board made key decisions,338 or by delegating decision making to a special committee of outside directors to “provide the appearance of integrity.”339 Courts ac-

334. See, e.g., Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 253 (7th Cir. 1986), rev’d on other grounds, 481 U.S. 69 (1987); Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 258 (2d Cir. 1984).
335. See, e.g., M. STEINBERG, CORPORATE INTERNAL AFFAIRS—A CORPORATE AND SECURI-
TIES LAW PERSPECTIVE 225-39 (1983) (arguing that defensive acts of a target company’s management should be put to a more rigorous review than the business judgment standard); Borowski, supra note 10, at 468-69 (characterizing the application of the business judgment rule in the control context as a “ritual dance”); Easterbrook & Fischel, Takeover Bids, supra note 299, at 1745-47 (arguing that the business judgment rule does not apply to takeovers); Easterbrook & Fischel, The Proper Role, supra note 299, at 1198 (arguing that the current applications of the business judgment rule do not prevent conflicts of interest); Greene & Junewicz, A Reappraisal of Current Regulation of Mergers and Acquisitions, 132 U. PA. L. REV. 647, 712 (1984) (questioning the use of the business judgment rule in tender offers); Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 COLUM. L. REV. 249, 266 (1983) (same); Note, Judicial Deference, supra note 287, at 1909-10 (arguing that deference to board approval “is based on false assumptions about the impartiality of the board”); Note, Tender Offer Defensive Tactics and the Business Judgment Rule, 58 N.Y.U. L. REV. 621, 655 (1983) (“The Business Judgment rule should not serve as an impenetrable shield for any defensive activity by target management.”); Note, supra note 332, at 1001-02 (noting the universal criticism of the Cheff presumption of independence); Note, False Halo: The Business Judgment Rule in Corporate Control Contests, 66 TEXAS L. REV. 843, 848-49 (1988) [hereinafter Note, False Halo] (contending that the business judgment rule should not apply in cases involving hostile takeovers); Comment, Anti-takeover Measures—What Standard Should Be Used To Evaluate Them?, 25 Hous. L. REV. 419, 437 (1988) (arguing that before a court applies the business judgment rule to director-initiated antitakeover measures, it must review the directors’ loyalty to shareholders).
336. Brudney, supra note 10, at 630 n.87.
339. Simpson, The Emerging Role of the Special Committee—Insuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions In-
Under the dominant motive approach, defensive tactics seemed unassailable, the only legal constraints being those imposed by corporate enabling statutes and federal regulation. Neither of these constraints proved meaningful. Courts interpreted the enabling statutes to allow management great flexibility in fashioning and implementing antitakeover strategies. And in 1985 in Schreiber v. Burlington Northern, Inc., the Supreme Court confirmed a nearly uniform set of lower court

volving Conflicts of Interests, 43 BUS. LAW. 665, 667 (1988). Although not as prevalent as the other techniques, delegating board decision making to a special takeover committee has been suggested by a number of courts. See, e.g., Hanson Trust, 781 F.2d at 277 (stating that appointing “an independent negotiating committee of outside directors . . . would have constituted one appropriate procedure under the circumstances”); Freedman v. Restaurant Ass’ns Indus., No. Civ. A. 9212 (Del. Ch. Oct. 16, 1987) (WESTLAW, De-cs database) (noting that outside directors are often named to a special committee to provide an “escape-hatch for the unprincipled” but finding no evidence of any such motive). When used, its success has been mixed. Edelman v. Fruehauf Corp., 798 F.2d 882, 886-87 (6th Cir. 1986) (upholding injunction of management leveraged buyout approved by a special takeover committee of outside directors); Dynamics Corp. of Am. v. CTS Corp., 635 F. Supp. 1174, 1176-77 (N.D. Ill. 1986) (invalidating poison pill recommended by special committee of outside directors), aff’d, 794 F.2d 250 (7th Cir. 1986), rev’d on other grounds, 481 U.S. 69 (1987); Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 275 (Del. Ch. 1986) (criticizing special committee for not retaining independent legal counsel or financial advisors); Greenfield v. National Medical Care, Nos. 7720, 7765 (Del. Ch. June 6, 1986) (WESTLAW, De-cs database) (denying a motion to dismiss because one of the committee members was interested and had not resigned).

340. See, e.g., Panter, 646 F.2d at 294 (“The presumption of good faith the business judgment rule affords is heightened when the majority of the board consists of independent outside directors.”); Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (finding that the presence of a majority of outside directors who consulted with an outside investment banker and a lawyer constitutes a “prima facie showing of good faith and reasonable investigation”); Moran, 500 A.2d at 1356 (stating that the likelihood of good faith is greater when a majority of the board is made up of outside directors); Unocal, 493 A.2d at 954-55 (stating that proof of good faith is “materially enhanced” by the presence of outside directors). Some commentators have chimed in hopefully: “An outside director can utilize management information but to some extent make an independent decision about proposed mergers or tender offers.” Anderson, supra note 55, at 787; see also Borowski, supra note 10, at 467-69 (reviewing the “heightened” presumption approach found under Panter); Leech & Mundheim, The Outside Director of the Public Corporation, 31 BUS. LAW. 1811, 1819-21 (1976) (suggesting that a committee of outside directors can maintain objectivity by meeting separately with outside advisors); Lipton, supra note 301, at 121-22 (noting that the board reviews independent information from investment bankers and outside counsel).

341. See, e.g., Moran, 500 A.2d at 1351 (upholding the issuance of rights to purchase preferred stock as a defensive tactic under Delaware statutes). A few cases, however, have relied on state enabling statutes to limit the range of the arsenal. See Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 269 (2d Cir. 1984) (Kaufman, J.) (enjoining a Panamanian corporation from issuing its common stock to a wholly owned subsidiary); Asarco Inc. v. M.R.H. Holmes A Court, 611 F. Supp. 468, 473-74, 477-80 (D.N.J. 1985) (interpreting the New Jersey enabling statute’s requirement that stockholders within a class have equal rights to invalidate “poison pill” rights that excluded a hostile bidder from voting its shares once rights were triggered); Lerman v. Diagnostic Data, Inc., 421 A.2d 906, 914 (Del. Ch. 1980) (enjoining directors from timing annual stockholders’ meeting to preclude insurgent nominees from submitting materials required by the company’s antitakeover bylaws).

342. 472 U.S. 1, 12 (1985). In narrowly interpreting § 14(e) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78n(e) (1982), the Court in effect concluded that management abuse is not a federal concern even if the effect of a defensive tactic is to preclude shareholders from tendering. This decision confirmed the view adopted in most circuits that the Supreme Court’s decision in 1423
cases holding that federal regulation is not available to review the merits of defensive tactics. The Williams Act’s antimanipulation requirement compels full disclosure, but not management accountability, in takeover fights.343

As it became clear that federal protection was unavailable, attention shifted back to the state courts, where the climate had begun to change. Acknowledging the dominant motive sophistry, courts applying state fiduciary law have recently begun to experiment with a variety of less deferential approaches: a “heightened” duty of care;344 a substantive “reasonable relation” test;345 and a quasi-loyalty analysis attributing management’s conflicting interests to outside directors.346 Of critical importance in each instance has been the role of directorial independence.

2. Heightened “Due Care”: Masked Substantive Review.—Recognizing the conflict inherent in the control context, but limited by available fiduciary tools, some courts have imposed a heightened duty of deliberative care.347 The parallel to Smith v. Van Gorkom is inescapable.

In 1986 the Second Circuit in Hanson Trust PLC v. ML SCM Acquisition, Inc.348 applied New York law to invalidate a crown jewel lockup option349 that SCM’s outside directors had conceded to a leveraged buyout group in the final stages of a heated takeover bidding contest.350 By granting the option at a price significantly below the locked-up divi-

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343. Schreiber, 472 U.S. at 12.
344. See Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 273 (2d Cir. 1986).
346. See infra subpart III(B)(4).
347. Due care has been part of the inquiry in reviews of control contests since nearly the beginning. A trilogy of 1980 decisions by the Second Circuit, in which the court discerned the exercise of “independent judgment,” illustrates the relative ease of demonstrating deliberative sufficiency. See Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 701-04 (2d Cir. 1980); Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 759 (2d Cir. 1980). In Treadway, for example, the directors hired an investment banker, were informed of and indirectly participated in negotiations with a white knight, sought pro forma balance sheets for the combined company and a fairness opinion, and adjourned for a week before approving the white knight merger. See Treadway Cos., 638 F.2d at 361-70.
348. 781 F.2d 264 (2d Cir. 1986).
349. In the language of corporate takeovers, “crown jewels” are those parts of a company’s business that have particular value—the major revenue or profit centers. “Lockup options” are contractual arrangements that give a potential acquiror an option to purchase assets (or stock) of the seller if the seller backs out of the deal or is acquired by a third party. The option price, usually below market, ensures that the seller will stay in the deal and compensates the buyer for its effort if the deal falls through. Crown jewel lockups also deter third-party acquirors. Once a lockup is executed the locked-up assets are no longer available to be acquired.
350. Hanson Trust, 781 F.2d at 266-73.
sions’ apparent value, the board effectively ended the bidding. But the court found no bad faith, fraud, or self-dealing. And the decision seemed to reflect a rational purpose, because in return for the lockups, SCM received a higher per-share bid from the management buyout group. The traditional fiduciary model left only inadequate board deliberations as a possible basis for invalidating the lockups.

The court concluded that the deliberations suggested that SCM’s outside directors were predisposed to the management buyout: the directors had not asked what the range of fair prices for the locked-up assets was or what effect the crown jewel sales would have on SCM’s business, nor had they asked for documentation to back up their investment banker’s advice. The court stated that in the control context, “a heightened duty of care” applies because of the pressure on outside directors to defer to management. After holding that the directors’ deliberations had failed this heightened scrutiny, the court then (curiously and confusedly) applied a fairness analysis to the directors’ actions. Evidence that the directors had violated their duty of care was sufficient, the court said, to shift the burden to the directors of proving that the transaction was fair. The court went on to conclude that SCM had not established that the option prices were fair and that it had agreed to the options (and effectively ended the bidding) for no other reason than to keep the management LBO “in the picture.”

Judge Kearse, who had authored two earlier Second Circuit decisions upholding stock lockups in takeover contexts, dissented vigorously. According to her, the majority focused narrowly on tangential

351. Id. at 277.
352. Id. at 274.
353. See id. at 270.
354. Besides Smith v. Van Gorkom, extant case law seemed to require very little deliberation. See supra note 347; see also Thompson v. Enstar, 509 A.2d 578, 581 (Del. Ch. 1984) (denying an injunction and approving under the business judgment rule outside directors’ approval of lockup); Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) (upholding under the business judgment rule a multimillion-dollar defensive acquisition considered during the first hour of a luncheon meeting).
355. Hanson Trust, 781 F.2d at 275.
356. Id. at 276.
357. Id.
358. Id. at 277. The court cited former SEC Commissioner Longstreth’s observation that “independent directors, even without evidencing ‘wrongdoing, venality or antisocial behavior,’ may improperly defer to management at the expense of shareholders.” Id. (citing Longstreth, Fairness of Management Buyouts Needs Evaluation, Legal Times, Oct. 10, 1983, at 15).
359. Id. at 277-78.
360. Id. at 277-81.
361. Id. at 283 (quoting MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1249 (Del. Ch.), aff’d mem., 505 A.2d 454 (Del. 1985)).
362. Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980) (Kearse, J.); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980) (Kearse, J).
deliberative oversights and failed to take into account the many questions the directors asked and had answered.\textsuperscript{363} The majority, she correctly pointed out, had disregarded New York law that deferred to board discretion and permitted directors to rely on advice.\textsuperscript{364}

Kearse's dissent forces the conclusion that the real failure of the SCM directors' decision was not that their deliberations were inadequate but that the lockup options prematurely ended the auction.\textsuperscript{365} That is, the court implicitly reviewed the substance of the transaction, applying a standard of substantive review higher than that of the traditional care regime. The court observed that when corporate assets are offered at a bargain price, a "heightened duty of care" is needed to ensure that the price is not "lower than 'reasonable pessimism will allow.'"\textsuperscript{366} Had the directors sufficiently informed themselves and then approved the lockup options as proposed, there is every reason to believe the result would have been unchanged. The "synergies of evidence" on the board's deliberations led, after all, to the court's inquiry into the value of the optioned assets.\textsuperscript{367} No amount of deliberations would have changed that the board effectively ended bidding after at most a "one dollar and change" improvement in price, and in return granted options for seventy million dollars less than the "lowest of all" estimates of value.\textsuperscript{368} In a context in which both management pressure was likely and in which conceding advantages to one bidder over another would likely deny shareholders full value, the board's action on the merits—because of its effect on shareholder welfare—failed to meet the court's heightened scrutiny.\textsuperscript{369} Hanson Trust's reliance on the Delaware Chancery Court decision in MacAndrews & Forbes Holdings v. Revlon, Inc.\textsuperscript{370} which had also concluded, though under a substantive "reasonable relation" test, that a sig-

\textsuperscript{363}. Hanson Trust, 781 F.2d at 285-91 (Kearse, J. dissenting).

\textsuperscript{364}. Id. at 285.

\textsuperscript{365}. The majority observed: "In the context of a self-interested management proposing a defensive LBO, the independent directors have an important duty to protect shareholder interests . . . . [T]he Board appears to have failed to ensure that alternative bids were negotiated or scrutinized by those whose only loyalty was to the shareholders." Id. at 277 (majority opinion).

\textsuperscript{366}. Id. at 276 (quoting Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 298 (1974)).

\textsuperscript{367}. See id. at 277-78.

\textsuperscript{368}. Id. at 279.

\textsuperscript{369}. Other courts have applied this approach. For example, in a case challenging a stock lockup in which the bidding process was not precluded and in which the boards' deliberations seemed (as reported) no more thorough than those in Hanson Trust, the Delaware Court of Chancery upheld the lockup primarily because there was "no evidence of harm to [the target's] shareholders." Hecco Ventures v. Sea-Land Corp., No. Civ. A. 8486 (Del. Ch. May 19, 1986) (WESTLAW, De-cs database).

significantly undervalued lockup option had brought an insufficiently higher bid—underscores the application of a heightened substantive test.

But the Hanson Trust rhetoric, remarkably similar to the Delaware court’s in Smith v. Van Gorkom, has led corporate planners, as well as litigants and courts, to focus (perhaps myopically) on boardroom deliberations. Certainly, planners can ill afford to disregard the courts’ preachings about deliberative process, and in some instances, this focus (unfortunately) seems to have carried the day. But it is an illusion. No board should be confident that cooked deliberations that produce results at odds with shareholder value will be enough. Judicial attention to boardroom deliberations may well be a common-law stopover on the way to a substantive approach.

3. Reasonable Relation: Intermediate Substantive Standards.— The idea of heightened intermediate standards (in between rational basis and fairness) in the control context is not new. It was unsuccessfully raised during the 1950s and 1960s in cases challenging management’s use of corporate resources in proxy fights. Although courts were slow to

371. Commentators and practitioners have already provided recipes for review-proof deliberations. See Veasey, Bodnar & Bennett, The Growing Complexity of the Business Judgment Rule, 19 INST. ON SEC. REG. 93, 115-17 (Practicing Law Institute Nov. 1987); Brownstein, supra note 185, at 178-82; Manning, supra note 3, at 8-14. One practitioner, for example, recently outlined the appropriate procedures for a special takeover committee. Assuming that a “special committee is likely to . . . enhance both the information gathering and deliberative function of the board,” Simpson, supra note 339, at 672, and the “appearance of integrity,” id. at 667, he advised that the committee: (1) retain an outside financial advisor and lawyer (who should “be knowledgeable about general issues of corporate and securities law and should also have specialized expertise in the area of corporate acquisitions,” id. at 679), (2) examine information “critically” and not rely blindly on advisors, (3) take its time, and (4) establish procedures for negotiating with management and other bidders, see id. at 678-89.

372. The corporate bar has noted the remarkable metamorphosis and emphasis on procedure, but has done little more than report the new judicial activism. See Block & Barton, Boards’ Role in "Hanson" and "Revlon", Nat’l L.J., Apr. 21, 1986, at 19, col 4; Greene & Palmiter, supra note 185, at S3, col. 1; Lerner, Impact of Heightened Judicial Scrutiny on Corporate Target’s Board Room, N.Y.L.J., Aug. 11, 1986, at 36, col. 1; Mirvis, Corporate Takeovers and the Business Judgment Rule: The Second Generation, N.Y.L.J., Aug. 11, 1986, at 37, col. 1.


375. For example, in Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 173, 128 N.E.2d 291, 293 (1955), the court wrestled with an incumbent board’s use of corporate resources to underwrite a proxy defense. The court considered three approaches. Three of the judges, applying a forgiving “polcy” rule (a variant of the dominant purpose test), upheld the challenged proxy expenditures. See id. at 173-74, 128 N.E.2d at 293. One judge, while suggesting that a more stringent standard might have been appropriate, concluded that there was insufficient evidence of abuse under the standard adopted. See id. at 175-76, 128 N.E.2d at 294-95 (Desmond, J., concurring).
articulate higher standards, \textsuperscript{376} they have now become part of the takeover landscape, widely recognized and advocated\textsuperscript{377} and increasingly used by courts. Although there are various formulations, each rests on an assumption of independent disinterested approval.\textsuperscript{378}

The most famous formulation has been the "reasonable relation" (or proportionality) test articulated by the Delaware Supreme Court in \textit{Unocal Corp v. Mesa Petroleum Co.}\textsuperscript{379} The court first recognized the requirement previously established in \textit{Cheff v. Mathes} that directors show "good faith and reasonable investigation" and that thereby "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" because of a takeover attempt.\textsuperscript{380} The court added a second test: "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed."\textsuperscript{381}

judges joined in a dissent rejecting the "policy" standard in favor of a rule shifting the burden of proof to the incumbents once the challengers showed "impropriety," which the dissent left undefined. \textit{Id.} at 178, 128 N.E.2d at 296 (Van Voorhis, J., dissenting, joined by Dye & Fuld, J.J.). The concurring and dissenting opinions' intimations of an intermediate approach, however, did not gain much momentum. See \textit{Studebaker Corp. v. Gittel}, 360 F.2d 692, 695 (2d Cir. 1966) (implicitly rejecting the intermediate approach by allowing management to seek an injunction against an insurgent group).

\textsuperscript{376} Federal courts purporting to apply California law were the first to apply intermediate standards. See Klaus \textit{v. Hi-Shear Corp.}, 528 F.2d 225, 234 (9th Cir. 1975) (placing burden of proof on target's directors to show a "'compelling business purpose'" (quoting Jones \textit{v. H.F. Ahmanson & Co.}, 1 Cal. 3d 93, 114, 460 F.2d 464, 476, 81 Cal. Rptr. 592, 604 (1969))); Royal Indus. \textit{v. Monogram Indus.}, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 95863, at 91137-38 (D. Cal. Nov. 29, 1976) (noting that the Ninth Circuit had adopted the compelling business purpose standard in \textit{Kraus} and finding that a proposed acquisition should be enjoined because it served no corporate purpose).

\textsuperscript{377} See, e.g., Brennan, \textit{New Cases on the Business Judgment Rule: Defending Defensive Tactics Becomes More Difficult}, 14 SEC. REG. L.J. 245, 263 (1986) (noting that the business judgment rule's use as "a regulatory mechanism for takeover contests" is limited); Brownstein, supra note 185, at 181-82 (noting the current Delaware formulation of business judgment rule in takeover contexts requires defenses "reasonable in relation to the threat posed") (quoting Unocal \textit{v. Mesa Petroleum Co.}, 493 A.2d 946, 955 (Del. Supr. 1985)); Gilson, supra note 68, at 878-79 (proposing a rule against target interference with tender offers); Johnson, \textit{Corporate Takeovers and Corporations: Who Are They For?}, 43 WASH. & LEE L. REV. 781, 783-84 (1986) (pointing out that commentators have widely advocated stricter judicial scrutiny of takeover defenses); Oesterle, supra note 301, at 88 (advocating a test requiring "clear and convincing evidence" that takeover responses are in shareholders' best interests); Wander & Lecoque, \textit{Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule}, 42 BUS. LAW. 29, 38 (1986) (noting the "very careful review courts are now undertaking" of corporate control decisions).


\textsuperscript{379} 493 A.2d 946 (Del. 1985).

\textsuperscript{380} \textit{Id.} at 955 (quoting Cheff \textit{v. Mathes}, 41 Del. Ch. 494, 506, 199 A.2d 548, 554-55 (1964)).

\textsuperscript{381} \textit{Id.} The Unocal court cited \textit{Cheff} for the procedural aspect of the test, not \textit{Van Gorkom}, which it had decided earlier the same year. It explained that "[t]he standard of proof established in \textit{Cheff v. Mathes} ... is designed to ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders."
Corporate Fiduciary Model

Although the result in *Unocal* was predictable—the court upheld Unocal's brilliantly executed exclusionary self-tender— the *Unocal* court's application of the substantive component seemed to make clear that the test required more than a rational basis. Requiring defensive tactics to hone closely to the threat that justifies them prevents directors from justifying the means by the ends and limits their opportunities to act on thinly veiled entrenchment motives. Nonetheless, despite its substantive inquiry, the *Unocal* court clung to the care rhetoric:

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.

*A C Acquisitions Corp. v. Anderson, Clayton & Co.* illustrates the teeth of *Unocal*'s reasonable relation test, as well as its limits. In a mas-
terful decision by Chancellor Allen, the Delaware Court of Chancery preliminarily enjoined a sixty dollar partial (sixty-five percent) self-tender that Anderson, Clayton made in response to a fifty-six dollar “any and all” cash offer by Bear Stearns & Co. and the Gruss group (the BS/G offer). Anderson, Clayton justified the self-tender not as a response to any inadequacy in BS/G’s fifty-six dollar offer but rather as an alternative for the company’s shareholders. Anderson, Clayton argued that its offer would allow the shareholders to retain an equity interest in the corporation, unlike the BS/G offer that contemplated cashing out nontendering shareholders. On this basis, the target’s self-tender seemed perfectly rational.

Nonetheless, Chancellor Allen—without discussing the adequacy of the board’s deliberations—concluded that the company’s self-tender was not reasonably related to this rational objective. Putting himself in the shoes of a rational shareholder, Allen concluded that the self-tender was hardly an alternative, but instead would “preclude as a practical matter shareholders from accepting the BS/G offer.” It created for shareholders a prisoner’s dilemma. By tendering into the BS/G offer, a shareholder stood to receive either (1) fifty-six dollars or (2) his

387. Id. at 116. In a subsequent case, Chancellor Allen applied a similarly toothy Unocal analysis in enjoining a target’s poison pill rights plan. Allen found that the board’s failure to redeem the rights had no reasonable relation to the threat of an allegedly inadequate “any and all” cash bid. City Capital Assocs. v. Interco Inc., 551 A.2d 787, 800 (Del. Ch. 1988).

388. AC Acquisitions, 519 A.2d at 109. The 14-person Anderson, Clayton board that approved the merger included 7 management directors. Id. at 110 n.8.

389. Id. at 109.

390. It was not for lack of evidence. The record indicated that the management directors participated in most of the deliberations, as well as in the final vote approving the transaction, and that the board never sought an opinion from an investment banker on whether the transaction provided greater value than the competing BS/G offer. See id. at 109-10.

391. Id. at 114. The court had to deal with Unocal’s narrow wording, which defined the “reasonable relation” test in terms of a threat. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 954, 955 (Del. 1985). The court noted that the Anderson, Clayton board did not seek to justify the self-tender as a necessary maneuver to fend off the threat of an unfair offer but as “the creation of an option to shareholders.” AC Acquisitions, 519 A.2d at 112. The court rephrased the test to consider whether the board was acting to further a “corporate purpose, not one personal to the directors.” Id. The court found that “a self-tender in these circumstances” met this test. Id.

392. AC Acquisitions, 519 A.2d at 113.

393. The prisoner’s dilemma, often used to explain the coercion felt by shareholders faced by front-end loaded tender offers, arises when two suspects are arrested, placed in separate rooms, and each told the following:

If you confess and the other does not, you will go free and the other will receive the harshest punishment; if you do not confess and the other does, you will receive the harshest punishment and the other will go free; if you both confess, you will each receive moderate punishment; if neither confesses, you will both be set free.

The rational prisoner, because he is unable to count on his fellow prisoner not confessing and wants to avoid the harshest punishment, confesses. Analogizing to the takeover context, shareholders faced with a coercive front-end bid that they would be better off rejecting collectively will accept individually to avoid losing a chance at the front-end takeover premium. See SEC Request for Comments on Two-Tier Tender Offers, 16 Sec. Reg. & L. Rep. (BNA) 1119, 1123 (June 29, 1984).
shares back if the BS/G offer was not sufficiently subscribed. By tendering into the Anderson, Clayton offer, a shareholder stood to receive either (1) sixty dollars for each share accepted and up to thirty-five percent of his shares back or (2) his shares back if the Anderson, Clayton offer failed. Anderson, Clayton’s investment banker had opined that if the self-tender was successful, the company’s shares would trade at between thirteen and eighteen dollars (their “stub value”). The overall Anderson, Clayton package therefore would be worth at most only forty-five dollars, far less than the fifty-six dollar BS/G offer. But no rational shareholder could risk tendering into the BS/G for fear that the Anderson, Clayton self-tender would succeed, leaving him holding all his shares with a thirteen to eighteen dollar stub value. The Anderson, Clayton offer was thus highly coercive and hardly reasonably related to providing the company’s shareholders an investment alternative. The court ordered that the self-tender’s coercion be corrected by requiring Anderson, Clayton to leave its offer open for a time after the BS/G offer had closed.

A fairness analysis would presumably have proceeded quite differently. The inquiry would have been, as in cases involving cashed-out shareholders, whether the price offered by Anderson, Clayton fairly reflected the company’s intrinsic value. But the AC Acquisitions court did not ask this question. Instead, the directors were given the latitude to construct a competing bid (fair or not), but no more. This is the essence of an intermediate “reasonable relation” standard.

The Unocal test is still maturing and is perhaps in danger. In Ivan-

But see Gilson, supra note 284, at 860-61 (arguing that the prisoner’s dilemma will rarely occur in takeover battles).

394. The range can be computed. Assume the shareholder tendered 100 shares to Anderson, Clayton. Assuming full subscription, 65 of the shares would be purchased at $60 each ($3900) and 30 shares would be returned, to trade at $13 to $18 ($390 to $540). The 100 shares would produce a total package of cash and stock worth between $4290 and $4440, far less than the $5600 they would have fetched in the BS/G offer.

395. After this convincing analysis, the court went into an avoidable tailspin. It held that because the transaction had failed the Unocal test, it had to be evaluated under an “intrinsic fairness” review. AC Acquisitions, 519 A.2d at 115. Treating the coercive self-tender’s entrenchment effect as an “unintended breach of duty of loyalty” and a “species of director interest even on the part of the outside directors,” the court concluded that the self-tender was unfair because it was unnecessary, thwarted shareholder opposition, and perpetuated management in office. Id. at 114-15. This analysis seems confused. It would have seemed that once the business judgment rule was pierced under the Unocal test, the directors breached their heightened Unocal duty—their “duty of care” under the traditional lexicon. It would certainly be strange for a takeover response not reasonably related to a corporate purpose to have been fair.

396. Id. at 116.

hoe Partners v. Newmont Mining Corp., 398 the Delaware Supreme Court took a significant step backward by upholding a series of transactions that left Newmont’s management unassailably entrenched for ten years under a standstill agreement with the company’s controlling shareholder. In response to a hostile two-tier tender offer by Ivanhoe (a T. Boone Pickens venture), Newmont first declared a special thirty-three dollar dividend to facilitate a “street sweep”399 by Newmont’s largest shareholder, Consolidated Gold Fields. The sweep allowed Gold Fields to acquire nearly fifty percent of Newmont’s stock, blocking the pending Ivanhoe offer.400 As part of the dividend-sweep plan, the Newmont board401 also negotiated a ten-year standstill agreement with Gold Fields. This agreement limited Gold Fields’ ownership of Newmont to 49.9 percent and its representation on the board to 40 percent of the total directors, required Gold Fields to vote its shares for the remaining board nominees,402 and prohibited Gold Fields from transferring its shares to any offeror that did not accept the standstill terms.

The coup could hardly have been more complete, and the Delaware court approved. Despite potent evidence of the Newmont board’s single-minded desire to fight off Ivanhoe’s bid,403 the court baldly accepted protecting Newmont’s independence as a legitimate justification.404 It is hard to imagine a case or a series of transactions that more powerfully evidence a dominant entrenchment motive. As a result of the market sweep and standstill agreement—together having the effect of a manage-

398. 535 A.2d 1334, 1346 (Del. 1987).
399. A “street sweep” is a large acquisition of stock on the open market, usually through purchases from arbitrageurs, during or shortly after a tender offer. See id. at 1337 n.3. The SEC and frustrated bidders have tried unsuccessfully in court to challenge street sweeps as an illegal tender offer under the Williams Act. See Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 60 (2d Cir. 1985); SEC v. Carter Hawley Hales Stores, 760 F.2d 945, 953 (9th Cir. 1985). The SEC recently proposed rules requiring large acquisitions of a company’s stock during or shortly after a tender offer to comply with the SEC’s tender offer rules. Acquisitions of Substantial Amounts of Securities and Related Activities Undertaken During and Following a Tender Offer for Those Securities, Exchange Act Release No. 24976 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84160, at 88871 (Oct. 1, 1987).
400. Ivanhoe Partners, 535 A.2d at 1337.
401. The Gold Fields representatives on the board recused themselves during these deliberations, and the board’s decisions were made by four outside directors and three management directors. That a majority of the directors approving the agreement were disinterested outsiders “materially enhanced” the board’s proof of good faith and reasonable investigation. Id. at 1343.
402. Id. at 1350.
403. The board approved golden parachute contracts for management and a $2.25 billion credit line that provided for default if any entity acquired a 50% interest in Newmont. Id. at 1338 n.7. It amended the bylaws to delay the effect of any solicitation of consents to replace the directors. Id. at 1339. It disclosed liberal estimates of reserves and gold production, which increased the value of Newmont’s stock. Id. at 1339 & n.7. Each maneuver increased the difficulty and cost of an Ivanhoe takeover. See id. at 1339-40.
404. Id. at 1334.
ment buyout financed entirely by nonmanagement assets\textsuperscript{405}—Newmont’s management was assured incumbency for ten years. The court nonetheless rejected a loyalty analysis on the ground that “the record does not support a conclusion that the directors appeared on both sides of the transaction, or that they derived any personal financial benefit from it which did not devolve from the corporation and the shareholders generally.”\textsuperscript{406}

Instead, the court decided that the coercive nature of Ivanhoe’s two-tier bid\textsuperscript{407} justified the Newmont board’s pursuit of a policy of corporate independence.\textsuperscript{408} Moreover, according to the court, the possibility of unfairness to minority shareholders in a back-end Gold Fields merger—something against which the \textit{Weinberger} entire fairness requirement presumably would protect—justified the board’s maneuvering to keep Gold Fields at bay under the standstill agreement.\textsuperscript{409} In the language of the court, Newmont’s board faced the threat that “Gold Fields now could wrest control away from the public shareholders”\textsuperscript{410}—presumably by offering them an acceptable price. The sophistry of \textit{Cheff v. Mathes} may have been revived.

Where was the reasonable relation test? The \textit{Newmont Mining} court’s explanations were unpersuasive, premised as they were on the idea that corporate independence was a legitimate business purpose.\textsuperscript{411} The court concluded that the thirty-three dollar special dividend was reasonably related to keeping Ivanhoe from acquiring control of Newmont’s gold assets and to facilitating the street sweep that Newmont could not have afforded on its own.\textsuperscript{412} The standstill agreement and street sweep kept Newmont “public” and were therefore justified.\textsuperscript{413} The public shareholders were, for ten years, effectively disenfranchised in the

\textsuperscript{405} The court also rejected the argument, based on the court’s earlier decision in Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986), that the transactions operated as a sale of the company and therefore triggered a duty of the board to become auctioneers. \textit{Ivanhoe Partners}, 535 A.2d at 1344-45. This aspect of the case seems as surprising as the rest. It is hard to understand how a 10-year standstill agreement that effectively gives a board full authority over its incumbency could be anything other than a sale of control.

\textsuperscript{406} \textit{Ivanhoe Partners}, 535 A.2d at 1341.

\textsuperscript{407} See id. at 1342. The court also noted that Newmont “recognized that Mr. Pickens, who controls Ivanhoe, had been involved in several attempts to acquire and break up other corporations, resulting in the payment of ‘greenmail’ or severe restructuring of the target companies.” \textit{Id}.

\textsuperscript{408} \textit{Id}. at 1345.

\textsuperscript{409} \textit{Id}. at 1347.

\textsuperscript{410} \textit{Id}.

\textsuperscript{411} See \textit{id}. at 1344.

\textsuperscript{412} \textit{Id}. at 1343-44.

\textsuperscript{413} The evidence suggests that the street sweep may have been as coercive as Ivanhoe’s tender offer. See \textit{id}. at 1343-44.
name of the "independent control and prosperity of Newmont."  

In Delaware, at least, a director's duty of independence in the take-over context may be less compelling than it at first seemed in *Unocal*.  

4. Imputed Interest: Drifting Toward Loyalty Review.—Some courts have shunned manipulation of the care regime and have imputed an interest to outside directors, thus triggering loyalty review. This approach had been urged by dissenters in the first wave of takeover cases in the 1980s.  

In *Edelman v. Fruehauf, Inc.*, the Sixth Circuit applied Michigan law to invalidate a management leveraged buyout approved by a committee of outside directors. The court treated a no-shop provision and concessions to the management buyout as evidencing a preference for management. To the court, this justified treating the outside directors "as interested parties," and it applied a fairness review to the outside committee's failure to ensure equal-access "open bidding." The committee's actions failed this demanding fairness review, even though it had extracted a ten percent increase in the buyout price.  

In *Dynamics Corp. of America v. CTS Corp.*, Judge Posner took a similar tack:  

When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the take-over attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority . . . . No one likes to be fired, whether he is just a director or also an officer. The so-called out-

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414. Id. at 1345.  
415. The *Ivanhoe Partners* court may have been trying to forestall legislative usurpation. At the time it decided the case, the Delaware State Bar Association was considering state antitakeover legislation that would have limited the importance of common-law fiduciary regulation. See Veasey, Finkenstein & Shaughnessy, *The Delaware Takeover Law: Some Issues, Strategies and Comparisons*, 43 BUS. LAW. 865, 867-68 (1988). The General Assembly later adopted a "business combination" antitakeover statute. See 66 Del. Laws 204, § 203 (effective Feb. 2, 1988) (codified at DEL. CODE ANN. tit. 8, § 203 (Supp. 1988)) (enacting a provision prohibiting 15% acquirors from engaging in specified back-end transactions unless (i) the acquiror's holdings were acquired in a tender offer to 85% or more of the company's voting stock or (ii) the board approves and two-thirds of disinterested shares are voted for the transaction).  
418. 798 F.2d 882, 886 (6th Cir. 1986).  
419. Id. at 885-87.  
420. See id. at 885-86 (increasing buyout price from $44 to $48.50).  
siders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer.\footnote{Id. at 256.}

Purporting to apply the \textit{Unocal} test, the Seventh Circuit considered the wealth-enhancing effects of an exclusionary poison pill, which entitled the target's shareholders to buy a package of common stock and debentures at a seventy-five percent discount upon any hostile fifteen percent acquisition.\footnote{Id. at 258.} Neither of the proffered justifications for the pill survived scrutiny.\footnote{See id. at 259.} Posner doubted that the bidder's offer was low,\footnote{See id. at 257.} as the target's board seemed to have concluded. Moreover, even if the offer was inadequate, Posner found that the pill's dilutive effect on the bidder and risk to the company's solvency constituted a greater cost than the pill's benefit.\footnote{Id. at 255.} He concluded that the pill was premature and too costly a reaction to the risk of a "disadvantageous 'backend' transaction."\footnote{Id. at 259.} The pill "effectively precludes a hostile takeover"\footnote{Id. at 255.}—a criticism that goes beyond the scope of review envisioned by \textit{Unocal}, as demonstrated in \textit{Moran v. Household International}.\footnote{500 A.2d 1346 (Del. 1985).}

\textbf{C. A Duty of Independence in Takeover Contests}

What has made the adaptive cases so hard is the dichotomy of the fiduciary model. A transaction in the takeover context, to take the most prominent mixed-motive case, has both enterprise and self-dealing characteristics, and one can make plausible arguments both for applying care review and for applying loyalty review. The argument in support of care review relies on management's unique vantage point (as in traditional enterprise contexts). Management is in a strong position to appraise the value of the corporation, the sufficiency of outside bids, and the desirability of potentially bid-maximizing defenses. And unlike classic self-dealing, the advantages of takeover defenses are available only through corporate transactions with necessarily entrenching effects. For example, golden parachute contracts can be purchased only from management, and the inducement of an asset lockup can be achieved solely by withdrawing the corporation's assets from other bidders. Validation by outside directors is a further palliative supporting care review.
Equally plausible arguments support loyalty review. Outside directors cannot be expected to be meaningful watchdogs; takeover defenses will likely reflect entrenching motives. Shareholders hardly grant management authority to make their buy-sell decisions or intend that management become accountable only to itself. Management is necessarily interested, and practically anyone beyond management’s range of influence, including judges, would do a better job at maximizing shareholder wealth.

This irreconcilable conflict with the traditional dichotomous model suggests that an intermediate approach is appropriate in the takeover context, and for that matter in any other context in which corporate decision making is motivated by a combination of conflicting interests and legitimate corporate purposes. The fiduciary model’s dichotomy begs for a middle ground. Some courts have begun to search for this middle ground. At the heart of these adaptive approaches—toward takeover defenses, dismissals of shareholder litigation, executive compensation, interlocking directorate transactions, and approvals of mutual fund investment advisor contracts—is the role played by disinterested, outside, purportedly “independent” directors.

The scene is set for formally recognizing a duty of independence.

IV. Structuring an Independence Regime

The existence of a duty of independence is perhaps only of passing interest. It explains the safety valve care cases and the mixed-motive cases, particularly in the takeover context, and offers a unifying theme: judicial reaction to the monitoring function of disinterested directors faced with actual or inherent conflicts. But by itself, it does not provide a coherent theory for evaluating whether a board has adequately performed its monitoring function. Developing that theory raises a host of questions about structuring standards of review in intermediate contexts and about structuring a duty of independence. (1) To what extent do outside directors behave independently in the face of management interest? (2) Even if outside directors are incapable of complete independence, is some judicial deference to their decisions (and indirectly to management initiatives) consistent with a goal of shareholder wealth maximization? (3) If it is, how much deference and what standards of review are appropriate?
A. Directorial Independence

1. The Traditional Fiduciary Model's Premise of Dependence.—Neither of the traditional regimes assumes the capacity of directors for significant independence from management influence. To the contrary, both the care and loyalty regimes contemplate that directors—in both enterprise and self-dealing contexts—will for the most part be dependent on management and will conform to management's desires. Management's motives become the motives of the board.

In enterprise contexts, the care regime encourages directors to be dependent on management and on each other both by statute and by the business judgment rule corollary that directors are entitled to rely on management advice. In fact, directors typically would be hard-pressed to choose an alternative course, because the board is generally dependent on the information management chooses and presents to it. Thus, both the law and the practicalities of corporate governance strongly encourage directors to conform to management's views. Dependence and conformance in enterprise contexts are eminently justifiable, because management interests will usually coincide with shareholder wealth maximization and because board cohesiveness helps implement management initiatives.

Likewise, the loyalty regime proceeds from an assumption that in interested contexts, interested parties will influence the outcome and disinterested directors (including outside directors) will be incapable of meaningful independence. The early prohibition of self-dealing, the mid-century abandonment of the requirement of disinterested validation, and the scrutiny of the fairness test each proceed from this premise.

430. Aside from state reliance statutes, see REVISED MODEL BUSINESS CORP. ACT § 8.30(b) (1984); MODEL BUSINESS CORP. ACT § 35 (1969), statutory requirements of (and preferences for) face-to-face board meetings underscore the directorial interdependence mandated by the care regime, see MODEL BUSINESS CORP. ACT § 43 (1969).

431. See Tent. Draft No. 3, supra note 8, ¶ 4.01(c) & comment b, at 50-51. The reporters of the ALI Principles explain:

The fact that directors (and sometimes officers) act as a group has important practical and legal implications. In becoming informed with respect to the subject of a business judgment, for example, a director (in addition to drawing on his own background) may learn from, or rely on, the discussions of his fellow directors as well as management presentations. . . . [I]nterpersonal factors (e.g., the value of maintaining board cohesiveness and of sustaining the morale of principal senior executives) may properly be considered by a director in performing his functions.

Id. introductory note a, at 2-3.

432. See supra note 82 and accompanying text.

433. See Haft, supra note 10, at 30-49. Management initiatives generally will have been hashed out before presentation to the board. See M. MACE, supra note 12, at 185; Eisenberg, supra note 9, at 377.
2. **The Nonindependence of Outside Directors.**—The economic and behavioral science literature largely supports the premise of the traditional model. Although proposals for corporate reform have placed their hopes on the role of outside directors as independent advisors, policy makers, and monitors of management, the capacity of outside directors for meaningful decision making or independence is at best questionable.

The institution of outside directors has received voluminous attention. In the 1970s, advocates of corporate social responsibility, corporate regulators (such as the SEC and the stock exchanges), and corporate reformers focused attention on the subject. Although each camp assumed remarkably different functions for this emerging institution, all assumed the possibility of an outside independent director remarkably different from the "dummy" director (a nominal outsider chosen by insiders to serve their purposes) known to the law before the 1970s. Many argued that the capacity of outside directors to act independently and meaningfully was limited by the process by which they were selected and retained and by the perceived deficiencies of the re-

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434. See, e.g., Dent, supra note 13, at 629-34 (evaluating the persuasiveness of the monitoring model, and contrasting this model to the traditional view of the board as corporate manager); Manning, supra note 13, at 1481-92 (presenting a useful, though largely anecdotal, description of the modern board's conduct).

435. See, e.g., R. NADER, M. GREEN & J. SELIGMAN, supra note 57, at 126-27 (arguing for the federal chartering of corporations and asserting that "[t]o maintain the independence of the board from the operating management it reviews also requires that each federally chartered corporation shall be directed by a purely 'outside' board"); Coffee, supra note 91, at 1143 (discussing the trend toward policing corporate misconduct through the institution of outside directors).

436. In enforcement actions, the SEC has insisted on the creation of monitoring committees controlled by independent, outside directors. See Hahn & Manzoni, The Monitoring Committee and Outside Directors' Evolving Duty of Care, 9 Loy. U. Chi. L.J. 587, 592 (1978).


438. See, e.g., Coffee, supra note 91, at 1147-56 (discussing corporate reform possibilities including outside directors); Eisenberg, supra note 9, at 385-90 (discussing proposals including professional directors, full-time directors, and fully staffed boards); Haft, supra note 10, at 1-67 (discussing the "new board" composed of independent directors).

439. See Dwight, Liability of Corporate Directors, 17 Yale L.J. 33, 35 (1907); Fuller, Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors, 26 Wash. U.L.Q. 189, 190-91 n.10 (1941). Dummy directors, under the traditional fiduciary model, were often held to the same standards as insiders. See, e.g., Hall v. Dekker, 45 Cal. App. 2d 783, 786-87, 115 P.2d 15, 17 (Dist. Ct. App. 1941) (holding dummy directors and a promoter of corporation liable to competing corporation of which the promoter was an officer, director, and shareholder); Golden Rod Mining Co. v. Bukvich, 108 Mont. 569, 575-77, 92 P.2d 316, 319-20 (1939) (holding an outside director, whose status as a competitor was known when he was nominated to the board, to the same corporate opportunity standards applied to insiders).

440. See Brudney, supra note 10, at 610-11.
ceived governance structure, which constrained their time, forced them to rely on information controlled by management, and limited their access to nonmanagement advice or assistance. Although these commentators widely acknowledged (with some empirical support) that management generally dominated outside directors, whose principal function was to rubber-stamp management initiatives, they imagined that structural changes would create new independence and a sense of responsibility on the part of outside directors.

The proposed solutions have been nearly as numerous as the writers. Among them are boards composed entirely of full-time nonmanagement professional directors; boards composed entirely (or substantially) of outside directors; boards composed of outside directors representing a spectrum of constituent interests; boards of well-compensated outside directors who would be independently advised by their own staffs; boards with audit, compensation, and nominating committees composed entirely or substantially of outside directors; boards of outside directors overseeing boards of management directors; and boards composed of outside directors nominated by shareholders. Reflecting the variety of their aspirations for the new board, scholars have focused attention on the issues of which structure, or combination of structures, would ensure the best decision making, make corporations more socially

441. See, e.g., Eisenberg, supra note 9, at 378-80 (noting the infrequency of board meetings, outside directors' limited access to information, and their limited ability to evaluate it); Small, supra note 91, at 1360 (pointing out that outside directors receive little notice or advance information); Williamson, supra note 57, at 1219 (noting the informational advantage that managers enjoy because of their full-time status). Not only do executives in fact choose the "watchdogs," but the watchdog who bites is quickly sent to the pound." Coffee, supra note 91, at 1234.

442. Haft, supra note 10, at 1; see also P. DRUCKER, supra note 12, at 628 (the board "was always the last group to hear of trouble in the great business catastrophes of this century"); M. MACE, supra note 12, at 15 (quoting a corporate president as saying, "[t]he board rubber-stamps the action of management, and the board members are there to mollify the outside stockholders"); Douglas, supra note 12, at 1313-14 (discussing the lack of power of management-dominated "'shirt-sleeve' directors").

443. See, e.g., Coffee, supra note 91, at 1149-50 (proposing a board of outside directors); Eisenberg, supra note 9, at 385-90, 404 (proposing full-time, professional directors to perform nonoperating functions, fully staffed boards composed of employees, and wholly independent boards); Haft, supra note 10, at 6-7 (proposing independent directors). Some advocates of structural solutions assumed that outside directors could be counted on to have traits of "character, maturity, and experience" and a "commitment to make the process work in the long-term interests of the private enterprise system." See Small, supra note 91, at 1403; see also Haft, supra note 10, at 62 ("[T]he honest, conscientious, and successful people on the new board—the 'achievers' with a strong sense of personal worth—would rather do something meaningful with the time they have committed to devote to the role.").

444. See Haft, supra note 10, at 11-12. Studies on group decision making indicate that because of an "assembly bonus effect," groups presented with a complex problem produce better decisions than individuals. Id. at 9. Further, the more internally cohesive their membership, the more effectively they will achieve their goals. Id. at 22.
responsible, and narrow the gap between ownership and control by assuring accountable shareholder representation on the board.

Others, however, have seriously and persuasively questioned whether outside directors have improved or can improve management accountability. Studies on group dynamics and the "structural bias" inherent in board membership raise doubts about the adequacy of any structural solution. Management (particularly the chief executive officer) dominates the corporate decision-making process, controls the nomination process, and sets the corporate agenda. Moreover, affiliated directors—such as members of outside law firms and investment bankers—have strong financial interests in maintaining a relationship with the corporation. Directorial independence may be, as an empirical and theoretical matter, a dubious myth. As Judge Cudahy observed in *Panter v. Marshall Field & Co.*, "[T]he very idea that, if we cannot trace with precision a mighty flow of dollars into the pockets of each of the outside directors, these directors are necessarily disinterested arbiters of the stockholders' destiny, is appallingly naive."

Whatever the merits of the institution of outside directors, the idea of greater outside representation on the board has appealed to management. Whether to increase the perception of corporate (and managerial) accountability and thus deflect criticism, to bring additional expertise to corporate decision making, to insulate management and the corpora-


446. See Anderson, supra note 55, at 779-80. A consensus holds that a board with outside directors, though deficient, is generally an improvement over a management board. See, e.g., Cary & Harris, supra note 29, at 64-66; Eisenberg, supra note 9, at 404-06; Jacobs, Business Ethics and the Law: Obligations of a Corporate Executive, 28 BUS. LAW. 1063, 1064 (1973); Wadmond, supra note 191, at 51. Nonetheless, there may be reason to have less confidence in outside directors in enterprise contexts, because they have less at stake than inside directors. See supra text accompanying note 82.


448. See Eisenberg, supra note 9, at 380. Outside directors, given their social and economic relations to management, will predictably identify more closely with management interests than with shareholder interests. See Brudney, supra note 110, at 607-16; Eisenberg, supra note 9, at 380-85.

449. See M. MACE, supra note 12, at 73; Brudney, supra note 14, at 1411-20, 1443; Dent, supra note 13, at 625; Haft, supra note 10, at 21; Manning, supra note 13, at 1481-92.

450. See Eisenberg, supra note 9, at 382.


452. See Brown, *Shareholder Derivative Litigation and the Special Litigation Committee*, 43 U.
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tion from liability in a perceived "age of corporate litigation,"\footnote{453} or simply to forestall further regulation,\footnote{454} boards with significant outside membership have become predominant in the last two decades.\footnote{455} In large public corporations, the outside director is now a well-implanted feature of the corporate governance landscape.

B. Recognizing an Independence Regime

The difficulties of reviewing corporate decisions in mixed-motive contexts compel the fashioning of explicit intermediate standards of review. Care review is inadequate. As traditionally applied, it is too deferential because it assumes the absence of interested motives and therefore the sufficiency of any enterprise justification. Loyalty review under a fairness test is also inadequate. The test is meaningless in many mixed-motive contexts and discounts any enterprise justifications by assuming instead that interested motives dominated.

Despite the doubts about the actual independence of outside directors, the idea of directorial independence is useful in fashioning intermediate standards of review for mixed-motive corporate decisions. An independence regime asks how a hypothetically independent board would have acted in the face of both inherent management interest and the possibility of uniquely valuable corporate action and provides a framework for balancing the mixed-motive tension. Even if actual directorial independence is improbable, the unique benefits of mixed-motive transactions argue for some judicial deference, subject to appropriate standards of measured review.

1. A Duty of Independence: Focusing Attention on Mixed Motives.—If nothing else, explicitly recognizing a duty of independence would cut through growing layers of doctrinal confusion sown by the care and loyalty rhetoric. It would be well to heed the admonition that "courts may go astray if their attention is focused too narrowly on a single line of precedent."\footnote{456} The fiduciary model's rhetoric breeds inflex-

\footnote{453} Caplin, \textit{supra} note 95, at 57. This movement toward boards composed of increasingly more outside directors has coincided, not surprisingly, with judicial recognition of intermediate fiduciary standards. \textit{See id.} at 71; Hahn & Manzoni, \textit{supra} note 436, at 591.

\footnote{454} \textit{See} Eisenberg, \textit{supra} note 9, at 384.

\footnote{455} \textit{See} Mace, \textit{The Changing Role of Directors in the 1970s}, 31 \textit{Bus. Law.} 1207, 1208-10 (1976); Small, \textit{supra} note 91, at 1356-57; cf. Brudney, \textit{supra} note 10, at 598 n.3 (noting the growth in outside directors between the late 1960s and 1977 and suggesting that outside director membership had topped out in 1982).

\footnote{456} Jacobs, \textit{supra} note 446, at 1066.
ibility. Recent case law is replete with instances of slavish (and often unfortunate) adherence to the ostensibly exclusive choices of the fiduciary model.457

But common-law courts are bound by notions of stare decisis (and federal courts by Erie federalism) to apply existing law or to stray from it cautiously and incrementally. It might be argued that the solution to doctrinal confusion is not the recognition of a broad-sweeping new regime but rather a fine tuning of the current fiduciary model. The ALI Principles, for example, takes just such an ad hoc approach, adhering closely to the received rhetoric of the traditional dichotomous model.458

Such an incremental, ad hoc approach suffers from a number of defects, most of which derive from operating in an ambience permeated by the care-loyalty dichotomy. First, the approach entails a start-up lag as courts develop standards for each new adaptive context. This period will necessarily be prolonged and confused, because courts likely will misfocus their attention on the two polar alternatives of the traditional model. The last decade of litigation over takeover defenses is a sad example of this lag. Second, the ad hoc approach creates the risk that the adaptations—such as the “due care” standard of Smith v. Van Gorkom—will be misunderstood and that courts or legislatures will overreact to them.459 When so much is at stake, confusion about the scope of limits on managerial discretion has great costs. Third, mixed-motive contexts place a premium on precisely balancing divided interests; in these contexts, common-law vagueness has little to recommend it. Although the in terrorem effect of a vague model may discourage managers from testing the outer limits of their discretion,460 it will also increase planning

457. See supra note 52. Even the Unocal test, which by its terms applies only to threatened changes in control, suffers from this assumption of exclusivity. See Grobow v. Perot, 539 A.2d 180, 189-91 (Del. 1988) (protecting corporation’s stock repurchase from nettlesome director under business judgment rule, without mentioning Unocal, since there was no threat of a takeover); see also In re General Motors Class E Stock Buyout Sec. Litig., 694 F. Supp. 1119, 1134-35 (D. Del. 1988) (same).


460. See Anderson, supra note 55, at 790.
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costs and chill desirable, innovative testing of those limits.\textsuperscript{461} Finally, an
ad hoc approach invites conceptual laziness, for it fails to treat the fiduci-
ary model as a unified set of principles. Instead, the ad hoc approach
continues to treat the model as an outcome-determinative choice between
abstention and intervention. By rejecting a model that includes alterna-
tive intermediate rules shaped by the contractarian, efficiency, and pru-
dential premises of fiduciary regulations, it tends to disregard theories of
shareholder wealth maximization.

The attempt to manipulate the care regime to handle mixed-motive
decisions through heightened "due care" standards illustrates that the
model's engrained rhetoric provides poor clay for the remodeling task.
Judicial abstention under the traditional care regime is premised on man-
agement interests coinciding with shareholder interests. It only invites
conceptual imprecision to say that directors must exercise care when
monitoring conflicts. And to speak of a business judgment rule in the
control context is to confuse the issue further by equating control deci-
sions to enterprise decisions. A new approach is necessary to focus judi-
cial attention away from the exclusive care and loyalty assumptions and
toward a finer, balanced analysis. As Bayless Manning observed, it is
time to recognize that "we are at a doctrinal dead-end and accept the
painful necessity of starting over again on a blank sheet of paper."\textsuperscript{462}

A duty of independence fills the gap and takes a step away from the
rhetoric of the polar traditional regimes. Taking this step helps courts to
fashion sound standards of judicial review and allows corporate decision
makers to plan and evaluate alternatives. By compelling a judge (and
perhaps a jury) to ask how an independent board would have acted and
how much deference is appropriate, a regime of independence focuses
attention on the mixed motives that confront the board. It sharpens the
inquiry and serves to avoid intransigent questions of boardroom due pro-
cess and imputed disloyalty. For corporate planners, it offers much more
meaningful terminology—outside directors will more easily appreciate
their role in mixed-motive contexts if their duty is said to be one of inde-
pendence, not just care. It will focus attention, as much of the academic
debate in the takeover context has, on the precise shareholder wealth
implications of a particular action.

Admittedly, this new regime introduces additional rhetoric to the
fiduciary model, for in the end even an outside board is not likely to be
actually or absolutely independent. Although a duty that seems unlikely

\textsuperscript{461} See Brudney & Chirelstein, supra note 366, at 303, 346.
\textsuperscript{462} Manning, supra note 14, at 1480.
to be fulfilled in the abstract may seem strange, even paradoxical, it is a paradox shared by the loyalty and care regimes. The fiduciary model defines standards of review, not subjective duties. Loyalty review does not turn on whether the interested insider was subjectively loyal to shareholder interests and, in fact, assumes that the insider was not. Instead, the loyalty regime asks how a hypothetically loyal fiduciary board would have behaved; the fairness test is a surrogate for this question. Likewise, care review does not turn on whether directors were actually careful in their deliberations, but rather on whether their decision can be justified as one a rational and careful board could have reached. The care standards defer to the board if it proffers a business purpose for its decision, regardless of subjective care.

A duty of independence merely creates a set of standards—a regime of judicial review—that applies in mixed-motive contexts. These standards are higher than those applied to enterprise decisions and more deferential than those applied to interested decisions. The duty of independence invokes these intermediate standards and describes that aspect of the dynamics of the decision-making process that the standards seek to test. Its rhetoric fits into the mainstream of the fiduciary lexicon by referring, as do “care” and “loyalty,” to the broad notion that should be on the fiduciary’s mind—indepe

2. Independence: A Concept Waiting To Be Born.—Recognizing a duty of independence is not as far-fetched a leap as it might seem; in fact, the seeds for such a duty lie within the lexicon of the case law of many jurisdictions. For example, the Delaware Supreme Court recently recognized that independence undergirds the operation of the fiduciary model. In Revlon, Inc. v. MacAndrews & Forbes Holdings,\textsuperscript{463} the court said, “While the business judgment rule may be applicable to the actions of corporate directors responding to takeover threats, the principles upon

\textsuperscript{463} 506 A.2d 173 (Del. 1986).
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which it is founded—care, loyalty and independence—must first be satisfied.”

Some courts and commentators have referred to a duty of independence, though without defining it. Heightened standards for reviewing control decisions and dismissals of shareholder litigation refer to independence as a necessary condition of the validity of these decisions. In the control context, courts speak of according greater deference to decisions by “independent” directors. Notions of independence also find expression in a variety of corporate rules. For example, some courts have justified prohibiting contractual limits on directorial discretion as necessary to ensure independent decision making for the protection of nonparties. In addition, the business judgment rule does not protect directors who rely on interested advice.

464. Id. at 180; see also Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) (inquiring into the independence of a shareholder litigation committee); Lewis v. Fuqua, 502 A.2d 962, 972 (Del. Ch. 1985) (“[A] stockholder’s welfare rests almost solely on the judgment and independence of his directors.”), appeal ref’d, 504 A.2d 571 (Del. 1986).

465. See Litwin v. Allen, 25 N.Y.S.2d 667, 677 (N.Y. Sup. Ct. 1940) (“He is required to use his independent judgment.”); Wadmond, supra note 191, at 54 (arguing that when “disinterested” directors accede to a “dominant” director, they violate “a wholly separate duty—that of the directors to the corporation”).

466. See, e.g., Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981) (allowing a court to dismiss shareholder derivative suits at a corporation’s request only if an independent committee concludes that dismissal is in the corporation’s best interests).


468. See McQuade v. Stoneham, 263 N.Y. 323, 328-29, 189 N.E. 234, 236-37 (1934); cf. Clark v. Dodge, 269 N.Y. 410, 415-17, 199 N.E. 641, 642-43 (1936) (holding that contracts limiting directorial independence are not illegal when directors are the only stockholders and the public remains unharmed, thereby limiting “the broad statement in the McQuade opinion . . . to those facts”). The common-law approach has been that shareholder agreements which restrain directorial discretion violate public policy because they limit independent judgment. But in close corporations, parties have greater power to limit directorial discretion (and independence) because the public policy implications of restricted independence are not as great. See, e.g., Galler v. Galler, 32 Ill. 2d 16, 28, 203 N.E.2d 577, 586 (1964) (upholding agreements to restrict independence when no public harm results).

469. A duty of independence in the face of interested advice is explored in two Second Circuit decisions concerning the duties of “disinterested” mutual fund directors under the Investment Company Act of 1940. See Tannenbaum v. Zeller, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95900, at 91344-45 (2d Cir. Mar. 4, 1977); Fogel v. Chestnutt, 533 F.2d 731, 749-50 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976). In each case, shareholders challenged the directors’ reliance on bad legal advice that the funds’ investment advisors were prohibited from negotiating discounts on brokerage services. In Fogel v. Chestnutt, the Second Circuit held that the directors could not rely on the fund’s attorney, who was also an officer, director, and part owner of the investment advisor. Id. at 749. In Tannenbaum v. Zeller, however, the court upheld the directors’ reliance on an outside law firm that represented both the advisor and the fund, apparently impressed that the firm had summarized the SEC’s and the New York Stock Exchange’s contrary views on the question. Tannenbaum, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91340-45; cf. Papilisky v. Berndt, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95627, at 90132-35 (S.D.N.Y. June 24, 1976) (holding that directors and investment advisor of mutual fund could not escape liability for failure to “recapture” brokerage commissions by asserting that they relied on advice of counsel who
3. A Duty of Independence: Testing It Against the Premises of the Fiduciary Model.—In the end, the real question is whether a separate intermediate regime operating primarily in mixed-motive contexts further the goal of shareholder wealth maximization. The answer depends—as it does for the care and loyalty regimes—on the contractarian, efficiency, and prudential premises that define the contours of fiduciary regulation.

(a) Contractarian: measured deference to centralized corporate governance.—In mixed-motive contexts, the statutory delegation to the board to manage and supervise the corporation’s business is of significantly diminished force. Near-complete deference to enterprise risk taking, though justified as to purely business decisions, is no longer justifiable as to mixed-motive decisions. Further, shareholders do not entrust their managers with authority to perpetuate their tenure in office, nor do they wholly entrust their investment decisions to the board.

On the other hand, the contractarian premise does not call for abjuring the significance of board governance in mixed-motive contexts. It is reasonable to hypothesize that shareholders would choose (and implicitly have chosen) to give significant latitude to directors and managers in such contexts. For example, federal and state statutes make it clear that the board is expected to play a role in control decisions. The board must approve any merger; it has access to (if not control of) the proxy machinery; and it is required to state its views concerning tender offers.470 Likewise, with respect to takeover defenses, the board is uniquely positioned to represent dispersed shareholders whose ability to act collectively is minimal. In derivative litigation, the board is authorized to defend against “strike suits”471 and in some jurisdictions to demand security for the expenses of litigation.472 This contractarian analysis suggests some deference.

(b) Efficiency: a cost-benefit analysis.—In mixed-motive contexts, outside directors, as well as managers, face mild market incentives represented both the fund and its advisor). The source and balance of the advice, not the directors’ deliberations, defined the contours of the duty of independence.


471. A “strike suit” is one in which a person who acquires knowledge of unredressed wrongs to a corporation purchases stock solely for the purpose of maintaining a derivative action. The plaintiff usually does not have the best interests of the corporation in mind, but sues in hopes of compelling a settlement. See 1 CORP. L. GUIDE (CCH) ¶ 336, at 772 (1987).

472. See, e.g., CAL. CORP. CODE § 800 (West 1986); N.J. STAT. ANN. §§ 14A:3-6(3) (1969); N.Y. BUS. CORP. LAW § 627 (McKinney 1986).
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and internal pressures to put aside personal interests in favor of corporate interests.473 Golden parachute contracts, for example, can align shareholder and management interests in a takeover fight. And outside directors and managers who work to entrench themselves or to dismiss well-founded shareholder litigation may encounter shareholder hostility at the next election. In addition, diversion in many mixed-motive contexts may be more difficult to hide than ordinary self-dealing or insider trading, increasing the chances that internal and market forces will deal with the problem. But by and large, internal and market incentives are as diluted in mixed-motive contexts as in interested contexts. Non-normative forces alone will not cause directors to put corporate interests ahead of personal interests.

The ineffectiveness of these constraints does not necessarily mean that the standards of judicial review should be the same in an independence regime as in the loyalty regime. In mixed-motive contexts, the board and management are uniquely able to use the corporate machinery to maximize shareholder wealth. Because the courts’ capacity to replicate these advantages is limited or absent, it is appropriate to give the corporate process some latitude. To impose a fairness review would narrow the board’s discretion and chill actions to seize unique corporate advantages. Judges, who must necessarily react after the fact, may be unable to improve upon the mixed-motive decisions of outside directors and managers. For example, although we might be confident that a judge could determine whether a particular defensive tactic achieved its avowed purpose, we would be less confident that a judge could evaluate whether the tactic was the optimal response to the situation.

But abstention is not the answer, either. We need judges to scrutinize management and guard against self-interest in mixed-motive contexts because outside directors have few internal or market incentives to do so. Judges, though not competent to decide enterprise matters, are more capable in mixed-motive cases. The cases will tend to involve discrete transactional questions—such as whether a poison pill plan served its avowed purposes or whether the corporation should have settled derivative litigation. They generally will not require judicial familiarity with the sweep of the business. To the extent business information on value or future prospects is relevant, the court can glean it through the litigation process from experts and corporate data. Perhaps most significantly, judges and the judicial process are particularly well suited to fathom divided loyalties and mixed motives. In most cases, the signifi-


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cant issue will be whether directors and managers justifiably pursued a particular strategy for business purposes or whether they were manipulating the corporate machinery for their own purposes.

(c) Prudential: allocating judicial resources.—Judicial review of many mixed-motive decisions will be nonrecurring, and prudential limits on judicial involvement may be for the most part unnecessary. For example, recourse to adjudication in takeover contests, though now an accepted incident of such contests, is usually not a recurring event for the same company. Of the innumerable decisions corporations make each year, only a few implicate corporate control. Likewise, corporate decisions to dismiss derivative litigation are relatively unusual. And once litigation begins, the procedural rules of derivative litigation require continuing judicial oversight to both the litigation and its settlement. 474

Prudential concerns are relevant, however, to the review of some mixed-motive decisions that do recur and require an inquiry into the minutia of a firm’s business. Not surprisingly, judicial standards for reviewing executive compensation decisions and approvals of investment advisory contracts by mutual fund directors, for example, are far more deferential. 475 Besides arising at least annually, these decisions inevitably raise issues that go to the heart of the enterprise and that can be resolved only by those intimately familiar with the business and with prevailing market conditions.

(d) Conclusion: the appropriateness of intermediate review.—This analysis indicates that in mixed-motive contexts standards of review will vary and that no one standard is appropriate for all situations. This variability seems clear enough from the fundamental premise of the independence regime that neither abstention nor full-fledged intervention works. But by asking how an independent board would have decided, thus focusing on the mixed personal and business motives, the inquiry stands the best chance of furthering shareholder wealth interests.

474. See FED. R. CIV. P. 23.1 (providing that shareholder derivative actions may not be dismissed or compromised without court approval).

475. See, e.g., Rogers v. Hill, 289 U.S. 582, 591 (1933) (finding executive compensation invalid if it has “no relation to the value of services”); Gartenberg v. Merrill Lynch Asset Management, 694 F.2d 923, 930-33 (2d Cir. 1982), (stating that to invalidate an investment advisor’s fee, it must be so large that it bears no reasonable relationship to services rendered), aff’d 528 F. Supp. 1038 (S.D.N.Y. 1981); Heller v. Boylan, 29 N.Y.S.2d 653, 680 (Sup. Ct. 1941) (stating that executive compensation will be upheld if “reasonable”); cf. S. REP. NO. 184, 91st Cong., 1st Sess. 15-16 (1969) (providing that the “ultimate test . . . will not be whether [an investment advisor’s fee] involves a waste of corporate assets but will be whether the investment advisor has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee”).

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C. The Nature of a Duty of Independence

Supposing the need for a duty of independence, the question then becomes that of "how external controls ought to be crafted and enforced, and whom they ought to target." Proponents of outside boards for public corporations have glibly noted that along with adequate compensation and self-imposed standards of responsibility, "the threat of legal liability . . . can make the outside director an effective supervisor of management on behalf of the shareholders." These commentators, however, have only obliquely discussed the dimensions of that legal liability and the tension between accountability and judicial deference.

The standards should not and need not be all-encompassing—that is, they need not be equally applicable to claims for damages against individual directors and those for equitable relief affecting the transaction. Instead, the inquiry can and should proceed on two tracks: (1) the standards applicable to a mixed-motive transaction's validity—"transactional" standards—and (2) the standards applicable to a director's individual liability for approving decisions that fail the transactional test—"liability" standards. For the most part, recent mixed-motive cases, with the glaring exception of Smith v. Van Gorkom, have involved only claims for injunctive or other equitable relief.

I first take up transactional standards in the independence regime and then liability standards.

1. Transactional Standards: A Substantive Reasonable Relation Test.—Intuitively, it seems that a director's duty of independence should be measured by his subjective freedom from others' influence. Probing financial and personal relationships, social attitudes, selection and retention procedures, information flows, and statements of motives would enable a court to discern whether a board's decision had been guided by


477. The duty of independence may be significantly different in the context of a close corporation. For example, if a director is elected to represent a particular shareholder or group, the specific mandate of his appointment might conceivably require him to ally himself with a particular group of directors. See Cleveland-Cliffs Iron Co. v. Arctic Iron Co., 261 F. 15, 18-19 (6th Cir. 1919); Marsh, supra note 41, at 58. In a public corporation, this alliance would violate a duty of independence.


479. See, e.g., Brudney, supra note 10, at 657 (noting the incongruity between requiring a director to be independent and "the reluctance of the courts and legislatures to provide him either with aid in doing so or sanctions for failure to perform"); Coffee, supra note 91, at 1229-41 (asserting that requiring directors to conform to an arbitrary definition of "independence" could inhibit the free flow of information, thus lowering the quality of their decisions); Johnson & Siegel, supra note 182, at 384 (arguing that "independent directors, subject to some judicial monitoring, can resolve the [target] directors' loyalty problem" in the corporate merger context).
conflicting interest. Certainly, a showing that directors were bribed to approve a colleague's interested transaction would shatter any pretense of their independence. But rarely will the direct evidence of independence, or lack of independence, be so conclusive. Human nature and circumstances vary. For some directors, being selected for board service carries with it a strong commitment to those who chose him; for others, it implies a personal responsibility of detachment and impartiality. Director's fees of $100,000 a year would for me be debilitating; for others they barely cover the nuisance.

Care and loyalty review largely avoid these fine, often impenetrable, questions of human nature, and an independence analysis need not give them much significance either. Instead, substantive review of a board's decision provides the most appropriate measure of whether a mixed-motive decision properly reflected the unique corporate benefits while avoiding the inherent risk of influence.

(a) Heightened substantive review.—Substantive review is the well-established mainstay of both the care and the loyalty regimes. The loyalty regime asks: "What would the result have been in an arm's-length transaction in which board members were not influenced by extraneous, conflicting interests?" The care regime asks: "What might the result have been had the board acted rationally to achieve some corporate purpose?" Each inquiry focuses on the result or the merits of the board's decision—just as shareholders would. The same kind of inquiry is appropriate for independence review: what would the result have been if the directors had been independent, free of management influence?

Significant considerations militate for greater judicial deference in the independence setting than in interested settings. For example, the promising "reasonable relation" approach of Unocal reflects the

480. See, e.g., International Radio Tel. Co. v. Atlantic Communications Co., 290 F. 698, 702 (2d Cir. 1923) (upholding a transaction on the grounds that a "reasonable body of men" would have entered "such a desirable transaction"); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 938 (Del. 1985) (noting that "divergence of transactions assured arm's length quality of the bargaining"); Johnston v. Greene, 35 Del. Ch. 479, 490, 121 A.2d 919, 925 (Del. 1956) (upholding a transaction on the grounds that an independent corporation would have entered it).

481. Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 254 (7th Cir. 1986) (noting that shareholders "want management to create a process that will maximize the value of their shares").

482. See City Capital Assocs. v. Interco Inc., 551 A.2d 787, 796 (Del. Ch. 1988) (describing Unocal as "the most innovative and promising case in our recent corporation law"); Gilson & Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to the Proportionality Review, 44 Bus. LAW. 247, 271-72 (1989) (arguing that a proportionality test that demands serious justifications for defensive tactics can serve an important screening function). A substantive approach is also appropriate and has been used in other mixed-motive contexts. In evaluating special litigation committees' motions to dismiss derivative litigation, for example, courts
unique benefits made possible by defensive tactics. The "reasonable relation" test, properly applied, determines whether the board acted to secure these unique benefits or to secure its and management's position.\textsuperscript{483} It is more circumspect than the traditional business judgment rule; not just any relation will suffice. Further, the test sets the parameters of the inquiry, while being sufficiently flexible to be adapted to special circumstances. Its use to uphold a pretakeover poison pill in \textit{Moran v. Household International}\textsuperscript{484} and to imply an auctioneer's duty in the middle of a bidding contest by two bust-up bidders in \textit{Revlon, Inc. v. MacAndrews & Forbes Holdings}\textsuperscript{485} demonstrates its flexibility.

This intermediate substantive review avoids easily misunderstood and readily manipulable structures and processes. It compels management either to design decisions (assuming board docility) that will survive heightened review or to ensure that the board is sufficiently independent and capacitated to make decisions that will survive such review.\textsuperscript{486} Conceptually, it tracks the approach of the care and loyalty regimes. It also works. Outside directors began taking their tasks in takeover contests and dismissals of shareholder litigation seriously only when the courts began to formulate heightened substantive standards of review.\textsuperscript{487}

\textbf{Footnotes:}

483. One commentator has suggested that the inquiry in the case of a takeover defensive tactic should focus on the target's performance (presumably poor performance indicates mismanagement and the likelihood of entrenchment), the size of the bid premium (presumably allowing greater latitude to the target if low), the structure of the bid (presumably front-end loaded bids justify greater latitude to react than "any and all" bids), and the structure of the defense (presumably coercive structures are more likely intended to entrench than to provide a higher price). \textit{See Note, False Halo, supra note 335, at 866-70.}

484. 500 A.2d 1346, 1356 (Del. 1985). The same test has also been used to invalidate the failure of a board to redeem poison pill rights during a bidding contest. \textit{See City Capital, 551 A.2d at 796.}


486. Group liability may reinforce group cohesiveness. \textit{Cf. Haft, supra note 10, at 27} (suggesting that placing different legal pressures on different members of a group diminishes group cohesiveness).

487. The behavior of a special committee of outside directors in the $25.4 billion takeover of
Intermediate substantive scrutiny thus seems a useful and necessary part of an independence regime. But to what extent should other, perhaps more intuitive, measures of independence—subjective independence in fact, board structures, and boardroom deliberations—be relevant to the inquiry?

(b) Independence in fact: a futile inquiry.—A number of commentators have suggested, and some courts have apparently accepted, an approach focusing on whether directors were actually "independent," deferring to their decision if they were and imposing loyalty review if they were not.488

Several problems militate against this proposal. The initial difficulty lies in defining "independence." Such definitions abound. Delaware courts have said directors are independent if they are in a "position to base [their] decision on the merits of the issue rather than being governed by extraneous considerations or influences"489 and nonindependent if "through personal or other relationships the directors are beholden" to a controlling person.490 Professor Coffee found the Black's Law Dictionary


489. Kaplan v. Wyatt, 499 A.2d 1184, 1189 (Del. 1985) ("The mere fact that a director was on the Board at the time of the acts alleged in [a shareholder derivative suit] does not make that director interested or dependent so as to infringe on his independent business judgment of whether to proceed with the litigation."); see also Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (relating independence to "influences upon the directors' performance of their duties"). Commentators discussing the independence of special litigation committees provide similar definitions. See M. Steinberg, supra note 335, at 146 n.68, 159-60 (defining independent committee members as those having no business or personal ties to management); Block & Prussin, supra note 32, at 71-72 (defining "independent" as "disinterested" in that the director is not party to the derivative litigation and has no pecuniary interest in the transaction in question); Dent, supra note 287, at 124-28 (defining independent committee members as those having no business or personal ties to management); Duesenberg, The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside, 60 Wash. U.L.Q. 311, 328-29 (1982) (defining independent as "disinterested").

490. Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984); see also Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971) (stating that "control" over and "domination" of directors so as to make them nonindependent "imply... a direction of corporate conduct in such a way as to comport with the wishes and interests of the corporation (or persons) doing the controlling"); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (finding independence when challengers fail to show dominance by insiders); Warshaw v. Calhoun, 43 Del. Ch. 148, 155-56, 221 A.2d 487, 493 (1966) (holding that allowing an entity to continue as a holding company, thereby preventing any accumulation of earnings or debt financing to make beneficial asset purchases, does not show a lack of independence); cf. Johnston v. Greene, 35 Del. Ch. 479, 485, 121 A.2d 919, 922 (Del. 1956) (finding domination when a nonvoting director conferred informally with other directors as to the undesirability of acquiring certain patents, resulting in a vote of the full board not to acquire the patents). In effect, a director is independent under this definition if he is neither interested nor controlled by an interested
definition of independence ("'entirely autonomous, and not subject to the . . . dictation of any exterior power'") "particularly appropriate." The federal securities laws provide various structural definitions that focus on specific (often quantifiable) relationships.

Whatever definition might be adopted, its application would be either highly problematic or unlikely to reflect shareholder wealth maximizing goals, and probably both. Under a flexible definition, courts (and planners and litigants) would face the nearly metaphysical task of discerning "entire autonomy" and "freedom from extraneous influence." Moreover, in view of management's influence over corporate decision making, it would be a meaningless inquiry in many (if not most) contexts. In others, unarticulated considerations would invite judicial manipulation to assure the desired outcome, as has happened when derivative suit plaintiffs claim that demand on a nonindependent board was excused.

party. This standard is highly factual and capable of manipulation. For example, courts typically have not considered a director who has a business relationship with a corporation to be interested or controlled. See Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir. 1981) (disagreeing with the argument that directors who worked for a corporation's investment banker could not be independent); Maldonado v. Flynn, 353 F.2d 789, 794 (2d Cir. 1979) (refusing to assume that a director was interested merely because his law firm did work for the corporation); Maldonado v. Flynn, 485 F. Supp. 274, 283 (S.D.N.Y. 1980) (describing the inference that a member of an independent investigating committee became interested when the committee hired his law firm as outside counsel as "non sequitur"), aff'd in part, rev'd in part on other grounds, 671 F.2d 729 (2d Cir. 1982); cf. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (finding the directors of a subsidiary interested because they were "on both sides" of a cash-out merger). The cases' narrow focus on pecuniary interests, rather than broader social and professional influences, has been criticized. See, e.g., Weiss, Economic Analysis, Corporate Law, and the ALI Corporate Governance Project, 70 CORNELL L. REV. 1, 20 (1984) (asserting that independence "is more a function of a director's character than of objective criteria").

491. Coffee, supra note 91, at 1231 (quoting BLACK'S LAW DICTIONARY 911 (rev. 4th ed. 1968)); see also Eisenberg, supra note 9, at 407-08 ("independent in fact as well as in form").

492. The Investment Company Act of 1940 prohibits a registered investment company from having "a board of directors more than 60 per centum of the members of which are persons who are interested persons" of the company. Investment Company Act § 10(a), 15 U.S.C. § 80a-10(a) (1982). The Act defines "interested persons" to include any person who (1) is an "affiliated person" (a 5% shareholder, officer, director, partner, or employee) of the investment company, (2) has an immediate family member who is an affiliated person of the investment company, (3) is an investment advisor of the investment company, an affiliated person of such an investment advisor, or has an immediate family member who is an affiliated person of such an investment advisor, (4) is a broker or dealer or an affiliated person of such broker or dealer, or (5) has acted as legal counsel to the investment company. Id. §§ 2(a)(3), (19), 15 U.S.C. §§ 80a-2(a)(3), (19).

493. See Daily Income Fund v. Fox, 464 U.S. 523, 545 (1984) (Stevens, J., concurring) (justifying substantive regulation of investment companies because independent directors cannot be trusted "to control excessive advisory fees"); see also Brudney, supra note 10, at 610-11 (detailing "practical considerations" stemming from management approval of directors and directors' desires not to frustrate management that "soften [independent directors'] adversary role"); Johnson & Siegel, supra note 182, at 382 ("[T]he term independent director is an oxymoron . . . ."); Solomon, supra note 13, at 584 (noting that outside directors "frequently have personal and business reasons for agreeing" with the chief executive).

494. See Aronson, 473 A.2d at 815 (effectively insulating compensation package from review by

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Even if courts were capable of ascertaining independence, applying loyalty review to nonindependent directors in mixed-motive contexts would solve little. This approach merely would make factual independence outcome determinative, and like the traditional fiduciary model, it fails to provide the intermediate substantive review called for by mixed-motive decisions. Finally, even though directors' personal and financial relationships to management might serve to disqualify their decisions, a failure to prove these relationships hardly seems a sufficient reason to uphold a mixed-motive decision.

(c) Deference to a restructured board: a doubtful proposition.—Enthusiasm for normative regimes relying on a restructured board may have reached its zenith during the debate in the 1970s on corporate responsibility. Some courts, however, have implicitly accepted the significance of a restructured board, particularly in their review of decisions by special litigation committees to dismiss derivative litigation.

In addition, the idea has resurfaced as a fundamental theme of the ALI Principles. What are the mechanics of this regime? Simply stated, courts would deferentially review decisions by a board or committee that has been restructured—through compensation incentives, composition guidelines, or information access—so as to fit a descriptive ideal.

The appropriateness of this structural solution depends on a number of important assumptions, each one wishful and none particularly convincing. First, this approach assumes that "[s]oon structure will transform to substance." In theory, even if structural changes could overcome outside directors' time, information, and staffing disadvan-

holding that directors chosen by controlling shareholder were nonetheless independent); see also Brudney, supra note 10, at 620 (concluding that independent directors rarely find that derivative litigation is in the corporation's best interests). That the factual independence inquiry is readily manipulable is shown in cases where the same directors have been found to be independent in some situations but not in others. Compare Tannenbaum v. Zeller, 552 F.2d 402, 426-34 (2d Cir.) (finding Chemical Fund's directors sufficiently independent that demand upon them before filing a derivative suit was not excused), cert. denied, 434 U.S. 934 (1977) with Wellman v. Dickinson, 475 F. Supp. 783, 828-30 (S.D.N.Y. 1981) (finding the same directors to have relinquished decision making to management in a sale of stock from Chemical Fund's portfolio), aff'd, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1069 (1983).

495. See supra notes 57 & 434-38.


497. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 7.10 comment a, at 170 (Tent Draft No. 8 1988).


tages, they would not alone be likely to create incentives for outside directors to maximize shareholder wealth at the expense of management interests. The disposition of outside directors (often acting in committee and counselled by outside advisors)\textsuperscript{500} to accede to management initiatives in the takeover context and to dismiss derivative litigation\textsuperscript{501} provides strong, though perhaps anecdotal, support for the theory that structure and procedures eventually conform to underlying forces:\textsuperscript{502} in the modern public corporation, the force is management. Even compensation incentives would be oriented necessarily to short-term gains and would not necessarily overcome inherent social and structural biases.

Second, a structural approach assumes that courts (or legislatures) will be able to identify ideal or a range of ideal structures. The tendency of courts to analogize the corporate decision-making process to the judicial process discredits their ability to construct a workable structural model.\textsuperscript{503} Moreover, fashioning an ideal structure is complicated by the changing nature of corporate governance from "managerial capitalism" to "finance corporatism,"\textsuperscript{504} and an ideal structure would have to vary from corporation to corporation. It also assumes a consistency in human nature and personal circumstances that is far too neat. A retired judge, newly elected to the board and placed on a special litigation committee, may act quite differently from a long-time accommodation director—though both might be viewed as having the independence supposedly created by a separate committee structure.

Nonetheless, a structure in which facially disinterested directors are given greater autonomy and access to information from sources other


502. See Eisenberg, supra note 9, at 439 (quoting F. KLEIN, DIE NEUREN ENTWICKLUNGEN IN VERFASSUNG UND RECHT DER AKTIENGESELLSCHAFT 55 (1904)). Any restructuring of the board, if meaningful, will cost management some control, thus limiting management's access to corporate resources. If management cannot circumvent the effects of the restructuring, it presumably will seek additional compensation for this loss. See Williamson, supra note 57, at 1215-20. The recent phenomenon of management writing itself golden parachutes triggered by a "hostile" change in control may substantiate the prediction.

503. See Manning, supra note 13, at 1481-94 (arguing that the "real world" conduct of directors diverges radically from the "images subsumed in the law's statement of directors' duties"). For example, it has been proposed that outside directors' compensation could be tied to stock price increases resulting from takeover responses. Oesterle, supra note 301, at 70. The ability of a court to judge whether a particular compensation formula creates sufficient incentives to insulate takeover tactics from scrutiny seems questionable.

504. The large, modern public corporation is increasingly structured as a multidivisional firm in which general managers oversee autonomous operating units, much as an investor oversees an investment portfolio. See Coffee, supra note 91, at 1139-41; Lipton, supra note 95, at 5-6; Williamson, supra note 57, at 1223. In effect, general management is put in the position theoretically occupied by the board. See Coffee, supra note 91, at 1142.
than management can only be an improvement over traditional board structures. The real, and appropriate, relevance of structure is illustrated in the post-Weinberger fair dealing cases. It cannot be flouted, but beyond serving as a coarse filter it is at best a road map for judging the merits of a transaction.

(d) Deference to the deliberative process: form over substance.—A close variant of a normative regime imposing an ideal corporate governance structure is one that focuses on the board’s deliberative process. But the “informed” and “reasonable investigation” tests suffer from the same deficiencies as a structural approach. Courts have at best haphazard notions of what deliberations will maximize shareholder wealth, and standards of corporate due process are invitations to subterfuge.

Take the case of Gimbel v. Signal Cos., in which the Delaware Court of Chancery enjoined a corporation’s sale of a subsidiary for an allegedly inadequate price. Management’s desire to freeze out a nettlesome minority group and to avoid a hostile takeover apparently motivated the sale. Although the court said that “the ultimate question is not one of method but one of value,” it described in detail a variety of purported deliberative transgressions leading up to the board’s approval of the sale. Would a three-hour meeting have been enough? Would it make any difference that the directors were highly incisive and quick? Would the grossly inadequate price have been any less inadequate to the shareholders, or the questionable motives any more palatable, if the board had considered the matter for two days?

Fiduciary regulation of the corporate deliberative process behaves

505. See infra II(B)(3)(a).
506. See Coffee, supra note 91, at 1108-09; Cohn, supra note 27, at 627; Manning, supra note 13, at 1480-81, 1500-01.
507. See Johnson & Siegel, supra note 182, at 332 (noting that directors can meet Van Gorkom’s requirement that directors inform themselves of all material information that is reasonably available “by recording the time, attention and information they gathered before making a decision”); Lowenstein, supra note 335, at 313-14 (arguing that since courts have begun to scrutinize takeover defense tactics for a retrenchment purpose, boards have continued to adopt the same “drastic” tactics, “but only at carefully orchestrated board meetings”).
508. 316 A.2d 599, 618 (Del. Ch.), aff’d, 316 A.2d 619 (Del. 1974).
509. See id. at 614.
510. Id. at 615.
511. See id. at 612-15. The litany of procedural flaws had a remarkable similarity to those cited in Smith v. Van Gorkom: the absence of advance notice to the board of management’s prolonged negotiations for the sale, short notice of the board meeting, no notification to outside directors of the meeting’s purpose, handwritten minutes that revealed a two-hour discussion, the board’s failure to consider adequately certain views on the sale’s legality, the failure to wait for an updated valuation of the subsidiary, a failure to discuss how the corporation would use the sale proceeds, and a failure to consider the disparity between market value and the sales price.
counter-intuitively: reviewing the process tends to be a poor measure of shareholder wealth.\textsuperscript{512} As Bayless Manning has argued, “[i]t would be intellectually neater for the courts to scrap the due care negligence analogy.”\textsuperscript{513}

*Smith v. Van Gorkom* and *Hanson Trust PLC v. ML SCM Acquisition* are powerful examples that deliberative review in mixed-motive cases has been essentially illusory, a mask for heightened substantive review.\textsuperscript{514} There are others. In *Zapata Corp. v. Maldonado*,\textsuperscript{515} the Delaware Supreme Court formulated a two-step test for determining when to grant a special litigation committee’s motion to dismiss derivative litigation. First, the court inquires into the committee’s independence, its deliberations, and its basis for its recommendation. If the court concludes that the committee is not independent or has not shown reasonable basis for its conclusions, or if the court is otherwise unsatisfied with the process, it will not grant the motion.\textsuperscript{516} Second, applying its “own independent business judgment,” the court engages in a substantive balancing of “legitimate corporate claims as expressed in a derivative stockholder suit and a corporation’s best interests as expressed by an independent investigating committee.”\textsuperscript{517} Both stages of the test necessarily force the court to the substantive question of whether corporate interests would be served by terminating the litigation. The committee’s deliberations and its report provide a useful and perhaps persuasive framework for this substantive inquiry, but in the end what matters is the court’s view of the merits of the litigation and of its dismissal.

Aside from its essential emptiness, process review may be inconsistent with the premise of intermediate review—the appropriateness of measured deference to disinterested validation. This deference would be undermined if courts imposed their notions of corporate due process upon corporate decision making and made causal predictions about whether some (as opposed to other) procedures would have resulted in a better outcome. Judicial interference is justified only when the process’s deficiencies, such as when the process is management-driven, adversely affect the outcome.

One might argue that management will lose any incentive to create

\textsuperscript{512} This postulate—that complex systems tend to behave counterintuitively, with the plausible tending to be wrong—was first advanced for complex political systems. See Coffee, *supra* note 91, at 1100-01 (citing J. Forrester, *World Dynamics* (1971), and J. Forrester, *Urban Dynamics* (1969)).

\textsuperscript{513} Manning, *supra* note 13, at 1500-01.

\textsuperscript{514} See *supra* text accompanying notes 160-86 & 349-74.

\textsuperscript{515} 430 A.2d 779, 787-89 (Del. 1981).

\textsuperscript{516} See *id.* at 788-89.

\textsuperscript{517} *Id.* at 789.
(or leave intact) salutary disinterested validation processes unless courts recognize their normative content.\(^{518}\) Put another way, an exclusively substantive review would eviscerate the effect of compelled management disclosure and disinterested scrutiny. As Professor Eisenberg has pointed out, requiring corporate boards to engage in "[e]ven pro forma review" of management initiatives would be "likely to inhibit practices which cannot stand even superficial scrutiny. Moreover, the mere expectation that review is required before a plan can become effective probably heightens the rationality of the decision process by inducing extra care in the preparation of proposals."\(^{519}\)

But at most this argument suggests that the law should not allow managers and directors to flout deliberative processes. It does not necessarily suggest that conformance to proper deliberative procedures should allow corporate decision makers to escape substantive inquiry. Focusing on a deliberative test, or for that matter any other structural test, creates a significant risk of false positives (liability for wealth-maximizing decisions, because courts will misunderstand the corporate decision-making process), as well as false negatives (no liability for diversion, because the process can be manipulated).\(^{520}\)

This is not to say that courts should abandon inquiry into the decision-making process. Fraud, including obtaining shareholder approval through misleading statements, should be a separate basis for invalidating a decision, regardless of its substantive sufficiency. And realistically, even if denied normative significance, the corporate deliberative process will set the agenda for judicial review\(^{521}\) and, if seemingly thorough and balanced, will lend credence to directors’ later arguments on the merits for a decision’s validity.

2. **Individual Liability.**—Up to this point I have assumed that the validity of a mixed-motive decision—a transactional question—should depend on a relatively searching inquiry into the decision’s merits. But recognizing intermediate standards of independence does not necessarily imply that standards for individual liability need be as stringent as those for equitable relief. Commentators have criticized the implication in *Van Gorkom* that care standards are the same regardless of the relief the plaintiff seeks.\(^{522}\) Moreover, a growing number of states have in effect

518. Cf. Coffee, *supra* note 91, at 1117 (discussing the efficacy of the SEC’s combination of positive and negative incentives with respect to foreign bribes).
519. Eisenberg, *supra* note 9, at 393 (footnote omitted).
522. See, e.g., Hinsey, *supra* note 17, at 611-613 (emphasizing the distinction between the busi-
statutorily rejected uniform transactional and liability standards.523

The question of damages liability has generally not surfaced in mixed-motive contexts,524 apparently because challengers have concluded as a matter of litigation strategy that raising the specter of staggering individual liability might undermine their main injunctive claims.525 Several commentators, however, have propounded a bifurcated approach to judicial review.526 Additionally, the ALI Principles adopts a bifurcated approach for reviewing both control decisions and disinterested validations of self-dealing. In both contexts, despite heightened transactional standards, the ALI Principles subjects directors to individual liability only under a traditional business judgment rule analysis.527

Bifurcation is perfectly justifiable. Uniform transactional and liability standards would produce unfortunate distortions. Directors subject
to liability under heightened transactional standards might understanda-
ibly act with moribund caution,528 and director flight and a crisis in the
availability of liability insurance might not be far-fetched.529 On the
other hand, if standards were uniformly diluted to a lowest common de-
nominator, transactional review would be diluted unnecessarily to pro-
tect against the effects of imposing individual liability where none is
sought.

A bifurcated standard would not mean that directors would be
shielded from all legal compulsion in mixed-motive contexts. The still-
present possibility of abetting liability (a straightforward form of inde-
pendence liability) would deter knowing acquiescence in a scheme of di-
version and would compel directors who get wind such a scheme to
become more watchful. And those who corrupt or dominate the process
would still be subject to individual loyalty liability.530 The lessons of
cases such as Litwin v. Allen and Francis v. United Jersey Bank,531 with
their more demanding standards of individual liability in contexts tainted
by actual or inherent interest, are not lost on public directors or their
counselors. The extent to which courts will interpret charter amend-
ments that limit director liability as extending to abetting liability re-
 mains to be seen.532 Moreover, having a decision invalidated—under
heightened substantive standards—would be a blow to a director's per-
sonal prestige and, assuming that a weak market in outside directors ex-

528. See Kraakman, supra note 476, at 892-93. The question, as an empirical matter, may be
virtually unanswerable. Consider the difficulties of a regression analysis of the impact of Smith v.
Van Gorkom on directorial risk taking and the premiums extracted by directors for the increased
exposure the decision caused.

529. This argument has to be taken with a grain of salt. Suggestions of heightened directorial
liability are uniformly met with dire predictions that desirable risk taking will be squelched, that
insurance will become unavailable, and that directors will abandon the risky fray. It happened in the
late 1960s. See Israels, A New Look at Corporate Directorship, 24 BUS. LAW. 727, 727 (1969) (re-
porting that the increased likelihood of liability during the late 1960s resulted in some directors
“running scared”). It happened again after Smith v. Van Gorkom. See Block, Barton & Garfield,
Advising Directors on the D & O Insurance Crisis, 14 SEC. REG. L.J. 130, 132 (1986); Hanks, State
Legislative Responses to the Director Liability Crisis, 20 SEC. & COMMODITIES REG. 23, 24 (1987);
Simpson, supra note 339, at 681 n.64; Veasey, Finkelstein & Bigler, Delaware Supports Directors with
a Three-Legged Stool of Limited Liability, Indemnification, and Insurance, 42 BUS. LAW. 399, 400-

530. See Tent. Draft No. 5, supra note 39, § 5.04 comment c(1), at 70-72 (providing that an
insider may not use influence to gain personal advantage). If, as seems likely, increased sanctions
against insiders who attempt to manipulate disinterested validation do not provide sufficient deter-
rence, “[e]levating [disinterested directors'] supervisory function to a legal duty enforced by personal
liability would be useful only if enterprise liability alone failed to induce adequate supervision.”
Kraakman, supra note 476, at 890.

531. See supra text accompanying notes 109-16 & 146-53.

532. I do not deal here with whether the liability limitation statutes, which often speak in terms
of “duty of care” liability, cover (or are intended to cover) a breach of the duty of independence.
The statutes and the charter provisions they often authorize would not, for example, appear to
change the results in the abetting cases. See Comment, supra note 523, at 535-38.
ists, would diminish his value. Management will also presumably have an incentive to replace exceedingly absent or egregiously lax outside directors, so long as they provide no other valuable service to the board, because such directors threaten the board’s validation function and may undermine shareholder confidence. There is little reason to believe that current approaches to director liability, besides *Smith v. Van Gorkom*, are insufficient.

V. Conclusion

The ultimate test of any legal thesis is its usefulness in explaining and guiding behavior. In postulating a duty of independence, the critical question is whether such a duty—and its accompanying regime of intermediate judicial review—either describes what courts have done or advances a theory of what they should do when directors are proffered as monitors of management diversion. A duty of independence does both remarkably well. It serves to debunk the simplistic notion bred by the dichotomous fiduciary model that corporate decision making is either untainted or driven by conflicting motives. The rules of care abstention and loyalty intervention, the natural and unfortunate legacy of the dichotomy, have proved inadequate in describing or finding judicial review of mixed-motive corporate decision making. The contorted results of safety valve and abetting cases in the care regime, the ambivalence toward directorial monitoring in the loyalty regime, and the confusion over the appropriate standards in takeover cases are manifestations of this legacy.

The traditional model and its rhetoric only tangentially address director monitoring, because neither assumes such a role for the board. Monitoring is antithetical to the care regime’s business judgment rule, which assumes monitoring is irrelevant. And the loyalty regime, as it stands now, reflects great reservations about the board’s monitoring capacity. Neither “diligence” nor “unflinching loyalty”—the care and loyalty rhetoric—describe the motivating judicial concern in mixed-motive cases. Instead, in the safety valve, abetting, and mixed-motive cases, the real focus has been on “independence,” whether stated or not.

But a coherent doctrinal basis for judging how well the guards are guarding is absent. The doctrinal gap is glaring in the safe-harbor proposals of the *ALI Principles* and the proposed Subchapter F of the *RMBCA*. The drafters of each are unable to point to any considered judicial analysis for removing conflict jurisdiction from the courts and

533. See Oesterle, *supra* note 301, at 70.
What then does a duty of independence do? It provides standards for judicial review of corporate decision making in contexts in which neither abstention nor full-blown intervention is warranted. It operates when interest is inferable or even clear but at the same time countervailing shareholders interests argue for judicial caution. It operates when the premises of the fiduciary model suggest that directors should be capacitated as monitors, and it provides the best means of juggling the underlying tension of the mixed-motive cases. The evolving standards in the takeover and special litigation cases make this clear: they are neither care nor loyalty standards—they are standards of independence. It is time to abandon the business judgment and fairness rhetoric and to focus critical attention on the contractarian, efficiency, and prudential premises of the fiduciary model. A duty of independence bridges the gap in these areas between the academic literature and the case law.

The operation of a duty of independence might best be illustrated by returning to *Smith v. Van Gorkom*. The *Van Gorkom* decision reflected two major failings. First, the court viewed the inquiry as limited to care or loyalty, failing to recognize explicitly (though applying implicitly) an intermediate ground. Second, and perhaps more significantly, the court assumed that fiduciary review (and in particular care review) is monolithic, equally applicable to a transactional challenge and to a claim for personal liability.

Consider how the case would have been decided under a reshaped care-independence-loyalty model. The initial inquiry would have been, as it is now, into the motives for the corporate decision—an identification of the decision-making context. Absent evidence that Van Gorkom had accepted a bribe from Pritzker to advocate the fifty-five dollar offer, an intrusive loyalty-fairness review of the merger would also have been inappropriate. And unless it could be predicted that the interests of Van Gorkom and the board were closely aligned with general shareholder interests in the merger, care abstention would have been inappropriate. But this evidence and prediction were lacking. The Trans Union merger, like most corporate acquisitions, had the key elements of a mixed-motive drama, with managers driven by worried thoughts of their own futures, as evidenced by Van Gorkom’s quick-sale perspective, and with a unique chance for the board to act on behalf of the shareholders. In short, the care and loyalty paradigms should have been rejected and the focus directed to whether the board acted with sufficient independence.

Turning first to the transaction, how would intermediate indepen-
dence review differ from arm’s-length fairness review? A fairness standard leaves the fiduciary little room to maneuver, an imposition that is entirely appropriate when conflicting motives are presumed to have dominated the decision-making process. “Fairness” demands that courts second-guess the terms of a deal. But an independence review assumes that some internal (management or board) maneuverability is appropriate. In mixed-motive contexts there is, by definition, the possibility for unique value. The premises of the fiduciary model argue for some judicial restraint. The question would not be whether the terms closely approximate what would have been obtainable in a hard-nosed bargain, but rather whether the terms preponderantly reflect the desirable, wealth-enhancing aspects of the transaction—a proportionality test.

The Trans Union merger price at the low end of an LBO range that failed to include the value of the company’s unusable investment tax credits and the structure of the deal (the no-shop terms and the stock lockup) should have raised some doubts, and the half-hearted conduct of the test market might well have confirmed them. This evidence could have been seen as showing that the deal tracked more closely the suspected Van Gorkom motives than general shareholder welfare. A higher price and a more vigorous test market would likely, and should, have changed the outcome.

The *Van Gorkom* court’s resort to a review of process, which has been widely and properly criticized, was an unfortunate consequence of the doctrinal limits of the care-loyalty model. Although process may buttress conclusions about a transaction’s substance, it should not be elevated in an independence regime (or any regime) to normative significance. Procedures are readily manipulable, and to require them (or, worse, to make them sufficient) merely invites subterfuge. The courts have for the most part understood this, and in an independence regime the Trans Union board’s process of corporate decision making should have been largely irrelevant.

Although to impose transactional liability in *Van Gorkom* may have been appropriate under intermediate independence standards, this does not mean that the directors should have been individually liable. As to the directors besides Van Gorkom, it was not a case of diversion. Their gain in abdicating to probable interested influence was at best indirect and marginal—their pockets were never lined. Liability standards that risk introducing timidity in the boardroom could have enormous costs both to investors, who expect enterprise risk taking, and to society in general, which depends on enterprise innovation. Too much incentive is counterproductive, and courts have understood this. The business judg-
ment rule proceeds on this premise, and the traditional care loyalty regime does not impose individual liability on directors who approve an unfair transaction unless they knowingly abetted the diversion. These Trans Union directors should not have been personally liable for approving the merger even though, from a transactional standpoint, their monitoring of Van Gorkom's interest was deficient. But Van Gorkom would certainly have fared less well under a loyalty standard, with his gains subject to an accounting.

A similar independence analysis works in other mixed-motive contexts. Much would be gained by trying it.