STRIKING A BALANCE ON DUE CARE LIABILITY OF CORPORATE DIRECTORS IN DELAWARE

by

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Abstract

Under the corporate statutes, a board of directors is vested with the power to manage the business and affairs of a corporation. The directors' statutory authority is tempered with fiduciary duties of loyalty and care rooted in the common law. Courts impose the duties of loyalty and care to protect the interests of a corporation and its shareholders from unfaithful and irresponsible directors. The duty of care is in place to assure that directors diligently attend their responsibilities. Directors are personally liable for the entire amount of damages suffered by a corporation as a result of a breach of the duty of care. Directors often make large-scale business decisions, and they may face draconian monetary liability for a breach of the duty of care. This may deter competent people from serving on corporate boards and may undermine responsible corporate risk-taking. Section 102(b)(7) of the Delaware General Corporation Law permits a certificate of incorporation to include a provision eliminating personal monetary liability of directors for a duty of care violation. After the enactment of section 102(b)(7), the duty of care virtually exists as an unenforceable legal standard. Section 102(b)(7) eliminates any meaningful threat of personal liability for "mere" inattentive director conduct. This may cause suboptimal director behavior in corporate decision-making or oversight. Behavioral psychology research indicates that the threat of punishment or even just the awareness of having one's behavior monitored is an important motivator of actor behavior. Accordingly, there should be an efficient enforcement mechanism for the duty of care. Directors should not be afforded a free-pass to ignore their due care responsibilities. Section 102(b)(7) pushes the fulcrum point between authority and accountability too far in favor of director authority. This runs counter to the traditional wisdom that authority should be accompanied by accountability. Therefore, there is a need for a balanced approach to revive an enforceable the duty of care while protecting directors from draconian monetary liability. Directors should not be afforded ex ante protection from personal liability for a duty of care violation. Where directors fail to act with due care, they should justify the challenged conduct in a court room on the basis of good faith. If directors are able to justify their due care failure on the basis of good faith, they should not be held liable for money damages. Under this middle-ground approach, the viability of a duty of care action would be maintained, and directors would be protected from draconian monetary liability.

To my deceased brother, Üsame, and my dear sister, Şeyma.
May Allah bring us all together in His Paradise.

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Table of Contents

Abbreviations

ABA	American Bar Association
CEO	Chief Executive Officer
CFO	Chief Financial Officer
BJR	Business Judgment Rule
DGCL	Delaware General Corporation Law
D&O	Directors and Officers
NASDAQ	National Association of Securities Dealers Automated Quotations
NYSE	New York Stock Exchange
RMBCA	Revised Model Business Corporation Act
PCG	Principles of Corporate Governance
SEC	Securities Exchange Commission
SLC	Special Litigation Committee
SOX	Sarbanes-Oxley Act of 2002
U.S.	United States of America

In the Name of Allah, the Most Beneficent, the Most Merciful.

CHAPTER I. INTRODUCTION

The business corporation plays a significant role in the modern economy. A substantial part of economic activity occurs and jobs and wealth are created through publicly-held corporations. The corporate form of business organization predominates in the leading sectors of the modern economy because it enables enterprises to collect funds from the public and invest in large-scale and long-term business projects. Traditionally, the corporation has been a highly desirable business form for large-scale enterprises that are to be publicly held.[1] A corporation is a legal entity which can exercise legal power and have rights and obligations in its own name.[2] In other words, a corporation has its own legal personality that makes it separate from its owners, managers, and employees. Shareholders, who are residual or ultimate owners of a corporation, are not personally liable for corporate obligations; their liability is limited to the amount they invest in a corporation.[3] The ownership status, however, does not entitle shareholders to manage the business and affairs of a corporation. One of the main characteristics of the corporate form is centralized management; that is, the separation of legal control from beneficial ownership.[4] Shareholders elect a board of directors, and the authority to manage the business and affairs of a corporation belongs to its board of directors.

Under the corporate statutes, a corporation is managed by or under the direction of its board of directors.[5] In performing board service, directors must act in the best interests of the corporation and its shareholders.[6] "To do so, they must focus on maximizing the value of the corporation for the benefit of its shareholders."[7] Because "directors are entrusted with power to use in the interest of others,"[8] they "stand in a fiduciary relation to the corporation and its stockholders."[9] The directors' fiduciary duties are an equitable response to the power that is

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[1] MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS: CASES AND MATERIALS 192 (11th ed. 2014).
[2] *Id.* at 191–92.
[3] *Id.* at 191.
[4] *Id.*
[5] *See, e.g.,* DEL. CODE ANN. tit. 8, § 141(a) (2011).
[6] CORPORATE LAWS COMM., ABA BUS. LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 11 (6th ed. 2011) [hereinafter CORPORATE DIRECTOR'S GUIDEBOOK].
[7] *Id.*
[8] Deborah A. Demott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879, 881 (1988).
[9] Guth v. Loft, Inc, 5 A.2d 503, 510 (Del 1939).

conferred upon them by the corporate statutes.[10] Equity imposes a fiduciary limitation on statutory authority to protect the interests of the corporation and its shareholders and to assure that directors truly act in accordance with the purpose for which they are elected.[11]

Traditionally, the directors' fiduciary duties are divided into two categories: loyalty and care. The duty of loyalty requires directors to prefer the best interests of the corporation over their own interests or any other extraneous consideration. Directors must act in good faith and in the best interests of the corporation. The honest belief and the best interests of the corporation must guide every action of directors. The duty of loyalty is in place to prevent directors from abusing their board position to advance their personal interest (or a related person's or institution's interest) at the expense of the corporation and its shareholders. The duty of care describes the manner in which directors must perform board service. The duty of care requires that directors act diligently, attentively, and on an informed basis when discharging their board responsibilities. The duty of care is in place to assure a diligent attendance to directorial responsibilities. Equity developed the concepts of loyalty and care over a century on a case-by-case basis, and the duties of loyalty and care reflect the fundamental values in performing board service.

The directors' statutory authority and their fiduciary responsibilities create a tension in corporate law. On one hand, directors are empowered with a discretionary authority to manage the business and affairs of a corporation. On the other hand, the common law imposes a fiduciary limitation on the board's authority. Directors are accountable to the corporation and its shareholders if they act in violation of their fiduciary duties. The tension between authority and accountability—deference to directors' decisions and the scope of judicial review—has been characterized as the defining tension in corporate law.[12] A strict accountability regime would inevitably reduce "the efficiency of corporate decision making."[13] Deference to the board's

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[10] *See* Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 678 (2009); Leo E. Strine Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 501 (2002) ("Delaware's enabling statute is premised on its use within a system of corporate law that uses the common law of fiduciary duties as an additional restraint on director action.").

[11] *See* Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("An underlying premise for the imposition of fiduciary duties is a separation of legal control from beneficial ownership.").

[12] *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A. 2d 914, 927 (Del. 2003) (citing E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 403 (1997)).

[13] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 129 (2004).

authority would necessarily involve a risk of "opportunism or even plain carelessness."[14] The legal precepts "that speak to when a court will intervene at the behest of stockholders in the decisions of the board of directors and impose liability on directors … for their business decisions are central" to corporate law.[15]

The primary precept equity developed over a century to create a balance between director authority and accountability is the business judgment rule. The business judgment rule recognizes that the authority to manage business and affairs of a corporation belongs to its board of directors; not to courts or its shareholders. A court will not substitute its own judgment for a board's business judgment at the behest of shareholders as long directors comply with the prerequisites of the business judgment rule. The business judgment rule precludes judicial inquiry into the substantive quality of a business decision and protects directors from personal liability even though a business decision results in an unfortunate outcome to the corporation. To be afforded business judgment rule protection, directors must exercise a disinterested, informed, and good faith business judgment that is attributable to a rational business purpose. The business judgment rule is the primary standard of review that defines the judicial inquiry into the directors' decisions. It operates as a presumption that directors exercise sound business judgments and are faithful to their fiduciary duties. Although the business judgment rule comes into play with respect to both the duties of loyalty and care, "it is most intimately associated with the duty of care."[16]

The duty of care has long been a controversial area of corporate law. While all agree that directors should act diligently, attentively, and on an informed basis, there is no consensus whether these objectives should rise to the level of an enforceable duty.[17] The scholarly debate in this area can be generally categorized into two groups. The first group argues that directors should not be held personally liable for corporate losses as long as they act in good faith and take minimal proceduralist steps when discharging their board responsibilities.[18] The second group argues that directors must discharge their board responsibilities with reasonable diligence, and

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[14] *Id.*
[15] Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).
[16] Bainbridge, *supra* note 13, at 88.
[17] *See* Kenneth B. Davis, Jr., *Once More, The Business Judgment Rule*, 2000 WIS. L. REV. 573 (2000).
[18] *See, e.g.,* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1307 (2000).

they should be accountable for their negligent conduct.[19] Under Delaware's business judgment rule, the directors' decision-making process is subject to judicial review under a lenient standard of gross negligence, and the substantive quality of a business decision is subject to judicial review under a very undemanding standard of waste (irrationality). Even Delaware's arguably balanced approach is far from satisfying corporate scholars at both ends.

This dissertation's specific focus is the corporate directors' duty of care. It attempts to provide a middle-ground approach with respect to the due care liability of directors. It argues that an efficient enforcement of directors' due care responsibilities is necessary for inducing heightened director attentiveness. It also recognizes that directors should not be subject to monetary liability for their actions taken in good faith. Accordingly, it suggests a two-step analysis to determine whether directors should be held liable for money damages for a duty of care violation. First, alleged due care failures should be subject to judicial review under a lenient standard of gross negligence. Where directors are found to have breached their duty of care, they should bear the burden of demonstrating that the challenged conduct was taken in good faith. If directors are able to justify their conduct on the basis of good faith, they should not be held liable for losses that the corporation may have suffered as a consequence.

This subject is a topic of public importance. As mentioned before, business corporations conduct a tremendous volume of business activities in the modern economy. Well-functioning corporations contribute to the welfare of a society by creating wealth and jobs and by furthering innovation. The corporate form enables the public to invest in enterprises without assuming managerial responsibilities and personal liability. This helps financing large-scale and innovative business projects. The legal rules that are in place to incent and control the individuals at the helm of corporations are vitally important for ensuring an efficient functioning of corporations and an efficient use of investment funds. An efficient corporation will contribute to the betterment of a society. Thus, corporate law and this subject closely relate to the public interest. This dissertation attempts to provide a legal framework that promotes both director engagement and corporate risk-taking.

This dissertation examines the corporate directors' duty of care under Delaware law. Delaware has long been the preeminent jurisdiction of business incorporation in the United

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[19] *See, e.g.,* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 312 (1994).

States. It is the leading jurisdiction for publicly-owned corporations listed on the stock exchanges. More than half of publicly-held corporations (including 64% of Fortune 500 companies) have incorporated in Delaware.[20] The primary advantage of incorporating in Delaware is its General Corporation Law. Further, Delaware courts are the leading judicial authority on corporate law in the United States. One commentator portrayed Delaware's authority by stating that Delaware judges "sit at 'the center of the corporate law universe.'"[21] The body of case law developed by Delaware courts provides guidance not only to other jurisdictions in the United States but also to the international corporate law community. Thus, this dissertation's exclusive focus is Delaware corporate law.

Section 102(b)(7) of the Delaware General Corporation Law permits a certificate of incorporation to include a provision exculpating directors from personal liability for money damages for a duty of care violation.[22] This dissertation argues that the statutory infusion of exculpatory provisions into corporate law disrupted the traditional fiduciary analysis developed by Delaware courts over the years. The liability regime created by section 102(b)(7) is not adequate for inducing heightened director attentiveness. Therefore, this dissertation proposes the repeal of section 102(b)(7) and provides an alternative approach with respect to the duty of care. It proposes a reinvigoration of an enforceable duty of care along with *ex post* liability protection. The directors' due care failures should be subject to judicial review at the instance of shareholders. Where directors are found to have breached their duty of care, they should bear the burden of demonstrating good faith with respect to the challenged conduct in order to avoid personal monetary liability.

This dissertation's proposal fits nicely into the existing legal framework under Delaware common law. In Delaware, a plaintiff is required to satisfy a standard of gross negligence to establish a breach of the duty of care. Although the gross negligence standard involves a lenient judicial review in favor of directors, unlike section 102(b)(7), it does not constitute a formidable barrier to a plaintiff challenging inattentive director conduct. In the decision-making context, a showing of a grossly negligent decisional process shifts the burden to the defendant directors to

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[20] *See* JEFFREY W. BULLOCK, DELAWARE DIVISION OF CORPORATIONS, 2012 ANNUAL REPORT 1 (2013), available at http://corp.delaware.gov/pdfs/2012CorpAR.pdf.
[21] Bainbridge, *supra* note 13, at 121 (quoting D. Gordon Smith, *Chancellor Allen and the Fundamental Question,* 21 SEATTLE U. L. REV. 577, 578 (1998)).
[22] DEL. CODE ANN. tit. 8, § 102(b)(7).

satisfy the entire fairness standard, which involves searching judicial scrutiny into both the process and substance of the challenged decision. This dissertation proposes that, in the duty of care context, the greatest weight should be given to the directors' good faith under an entire fairness review. In the oversight context, if a plaintiff demonstrates a grossly negligent oversight failure, the directors should bear the burden to demonstrate that they have otherwise made a good faith effort to discharge their oversight responsibilities.

The organization of this dissertation is as follows. Chapter II provides some background on fiduciary law and the role of a board of directors in a corporation. Chapter II also examines the role fiduciary law played in the historical development of corporations. Chapter III examines the journey of the duty of care in Delaware, the business judgment rule, and the relationship between these two. It starts with explaining the divergence of standards of conduct and review, it then examines the standards of care and review in the decision-making and oversight contexts. It also provides a brief overview of the standard of care under the Principles of Corporate Governance and the Model Business Corporation Act. Following, it explains the business judgment rule doctrine in detail. It then examines the landmark corporate law case of *Smith v. Van Gorkom*[23] and the legislative response (section 102(b)(7)). Chapter IV examines the duty of loyalty and good faith. It starts with examining three common law periods governing interested director transactions. It then examines the statutory provision regulating self-dealing director transactions (section 144) and its relation to the common law rule. Following, Chapter IV examines the prominent corporate law case of *In re The Walt Disney Company* and the emergent role of good faith in corporate fiduciary law. Chapter V examines shareholder derivative suits and the director demand requirement. Chapter VI concludes that section 102(b)(7) virtually eliminates any meaningful threat of personal liability for inattentive conduct, and this may not be adequate for deterring directors and protecting the corporation and its shareholders from irresponsible behavior. Chapter VI proposes a reinvigoration of the duty of care along with *ex post* liability protection for good faith conduct to encourage director attentiveness while promoting responsible risk-taking.

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[23] 488 A.2d 858 (Del. 1985).

CHAPTER II. A BRIEF HISTORY OF FIDUCIARY LAW AND THE ROLE OF THE BOARD OF DIRECTORS IN CORPORATIONS

A. Fiduciary Law in General

1. Fiduciary Relationships

As human beings, we must depend and rely on the expertise of other people in a society. Fiduciary law derives its roots from this reliance. When one relies on the service of another person, the law classifies the latter as a fiduciary. Accordingly, the law imposes certain obligations on the fiduciary because this reliance "implies a condition of superiority of fiduciary over the other."[24] In general terms, a fiduciary is a person who has a duty to act in the interest of another person.[25] In fiduciary relationships, fiduciaries discharge business, or manage money or property for the benefit of the other party, and not for their own benefit.[26] The concept of fiduciary embraces a wide range of relationships in our daily life. Physicians, lawyers, trustees, agents, financial advisors, and corporate directors and officers are examples of fiduciaries.

Trust and dependency are essential characteristics of fiduciary relationships.[27] "A fiduciary relationship imparts a position of peculiar confidence placed by one individual in another."[28] The dependent party vests the fiduciary with discretionary power, with the expectation that the fiduciary will exercise that power for her benefit. Typically the beneficiary has a continuing relationship with the fiduciary "that resists complete specification by agreement or contract and instead bestows discretions."[29] Thus, a fiduciary "is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of the behavior."[30]

The many agency relations that fall under the fiduciary context are so diverse that stating a general definition of fiduciary relationships covering every legal position is practically impossible.[31] In *Worldspan, L.P.*, the court emphasized the situation-specific characteristic of fiduciary relations by stating that since the existence of a fiduciary relationship depends on the

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[24] Dension State Bank v. Madeira, 640 P.2d 1235, 1241 (Kan. 1982).
[25] Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539, 540 (1949).
[26] Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities Revisited*, 61 U. KAN. L. REV. 923, 925 (2013).
[27] Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 430 (1993).
[28] First Sec. Bank of Utah v. Banberry Dev. Corp., 786 P.2d 1326, 1333 (Utah 1989).
[29] TAMAR FRANKEL, FIDUCIARY LAW 4 (2011) (citing Joshua Getzler, *Duty of Care*, in BREACH OF TRUST 41 (Peter B.H. Birks & Arianna Pretto eds., 2002)).
[30] Meinhard v. Salmon, 164 N.E. 545, 546–47 (N.Y. 1928).
[31] FRANKEL, *supra* note 29, at 2; Demott, *supra* note 8, at 922.

facts and circumstances of each individual case, "there is no invariable rule which determines the existence of a fiduciary relationship."[32] Similarly, Justice Frankfurter of the United States Supreme Court noted that "to say a man is fiduciary only begins analysis; it gives direction to further inquiry."[33] While dealing with the facts of a particular case, the courts often base their definition of fiduciary relationships on a detailed list of elements.[34]

In her treatise regarding fiduciary law, Tamar Frankel states that while the definitions of fiduciaries are not identical, all definitions share three main elements: "(1) entrustment of property or power, (2) entrustors' trust of fiduciaries, and (3) risk to the entrustors emanating from the entrustment."[35] In addition to these elements, the definitions may contain more detailed features that distinguish one species of fiduciaries from another. Yet, these differences derive from the nature of the three main elements in fiduciary relationships.[36] Thus, some fiduciary relationships are more intense than others. "The greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty."[37] The laws of trust and agency provide good examples of fiduciary relations with different legal grounds.[38]

Agency is a fiduciary relation where a person (agent), by mutual consent, acts on behalf of a principal and is subject to that principal's control.[39] In agency, although a principal entrusts power to the agent, the level of risk which arises from the entrustment is low because the principal is able to control the agent's actions.[40] In a trust, however, there is no mention of control of the power and the beneficiaries' consent to the arrangement. Trust is created when a property owner entrusts property to another, requiring the trustee to manage the entrusted property for the benefit of specified beneficiaries.[41]

The difference between trust and agency derives from the risk level of abuse of entrustment and the ability of the entrustors to control such abuse.[42] In a trust, the trustee is bound by the trust document and the beneficiaries do not have control over the trustee. In

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[32] Manassas Travel, Inc. v. Worldspan, L.P., 2008 U.S. Dist. LEXIS 35217 at *10 (D. Utah Apr. 30, 2008).
[33] SEC v. Chenery Corp., 318 U.S. 80, 85–86 (U.S. 1943).
[34] FRANKEL, *supra* note 29, at 1.
[35] *Id*. at 4.
[36] *Id*. at 5.
[37] Scott, *supra* note 25, at 541.
[38] RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006); RESTATEMENT (THIRD) OF TRUSTS § 2 (2003).
[39] EISENBERG & COX, *supra* note 1, at 2.
[40] FRANKEL, *supra* note 29, at 5.
[41] *Id.*
[42] *Id.*

contrast, the agent is bound by the principal's consent and control. Therefore, a trustee is under stricter fiduciary limitation than is an agent upon whom limited authority is conferred.[43] The fiduciary status of corporate directors, on the other hand, provides more unique example compared with fiduciary status of trustees and agents. The directors of a corporation are entitled to exercise an unconstrained authority when they manage the business and affairs of a corporation. In contrast to trust and agency, directors are not bound with any document or strict principles and not subject to control of shareholders. Fiduciary law ensures that directors act with due care and in the best interest of corporation and its shareholders. Thus, fiduciary obligations of corporate directors have a great importance and are one of the key elements in the governance structure of corporate form.

Nevertheless, the fiduciary law plays an important role in most legal relationships that we encounter in our daily life. The fiduciary law is designed to ensure that fiduciaries do not misuse the trust placed upon them. Indeed, the fiduciary concept developed through imposition of trust law principles in other legal relationships where it is suitable. Today, like corporate directors, all fiduciaries are generally subject to fiduciary duties of care and loyalty. The next section provides a brief overview of the development of the fiduciary concept in general.

2. The Roots of the Fiduciary Relation: Trust Law

The fiduciary concept had its origin in the law of trusts.[44] In trust, faithfulness which is literal meaning of fiduciary describes the duty or responsibility owed by one who held legal title, but not beneficial ownership, to property of another, who lacked legal title but could claim the benefits of ownership.[45] The former individual, who holds the property for another's benefit is referred to as the trustee and the latter individual who is benefited by trust is referred as to the

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[43] Scott, *supra* note 25, at 541.

[44] *See* Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333 (2002). *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); *see also* L.S. Sealy, *Fiduciary Relationships*, 20 CAMBRIDGE L.J. 69, 70 (1962). Sealy states that, in the eighteenth century, all legal relationships which repose confidence were naturally called "trusts," whether there was any strict trust of property or not. "So long as the relief meted out by the Lord Chancellor followed broad principles and involved a degree of discretion, a simple legal vocabulary relying on general words such as "trust" and "confidence" was adequate." *Id.* In time, however, discretion based broad principles gave way to concrete rules and descriptive words, such as trust and confidence gave way to precise terms. The word "trust" came to be recognized as a formal term with its modern technical meaning and other situations formerly described vaguely as "trusts" were now left without a name. In the early years of nineteenth century, the courts asserted that relationships which reposed confidence were "quasi-trust" or said that the relationship was "in some respects" or "for limited purposes" one of trusteeship, or "similar" to trusteeship. Later on, the word fiduciary was adopted to describe these situations which fell short of the now strictly-defined trust. *Id*. at 72.

[45] Walsh, *supra* note 44, at 333.

beneficiary. The common law imposed quite rigid standards on faithfulness of trustee to the beneficiary.[46] Courts required trustees to manage the trust prudently and prohibited them from personally dealing in trust property even if that dealing did not harm the interests of the beneficiary.[47]

The law of fiduciary obligation has developed through analogy to trust in which the obligation conventionally applies.[48] Judicial opinions resorted to analogy to examine whether the relationship involved in the litigation was sufficiently like trust to support an extension of the obligation to that relationship.[49] Courts adopted the fiduciary term to apply to situations falling short of trusts, but in which one person was nonetheless obliged to act like a trustee.[50] The rules and principles governing fiduciary relationships were, in essence and in origin, the same as those of the law of trusts.[51] In *Ex p. Dale* the court stated that "a fiduciary relationship is one in respect of which if a wrong arise, the same remedy exists against the wrongdoer on behalf of the principal as would exist against a trustee on behalf of the *cestui que trust*."[52]

In time, however, strict analogy to trust gave way to broad principles and flexibility in fiduciary law. Today, the word "fiduciary" embraces all trust-like situations, including the trust itself. It is not definitive of a single class of relationships to which a fixed set of rules and principles apply.[53] The mere statement that a relationship falls under the fiduciary concept means no more than that in some respects the fiduciary is in a trustee-like position.[54] Falling under the fiduciary concept does not warrant that the all trust principles will apply to the fiduciary relationship, because the fiduciary concept covers such diverse legal relations that strict application of trust principles will not fit all situations. Each fiduciary relation is fact-specific and requires special treatment.

Thus, the evolution of fiduciary law owed much to its flexible and fact-specific characteristics. These features of fiduciary relationships also resisted a tidy categorization. Judges made their analyses first to determine whether the relationship before them involved the

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[46] *Id.*
[47] *Id.*
[48] Demott, *supra* note 8, at 879.
[49] *Id.*
[50] *Id.* at 880.
[51] Sealy, *supra* note 44, at 72.
[52] *Id.*
[53] *Id*.
[54] *Id.* at 73.

fiduciary element, and if so, they determined to what extent one of the parties in the relationship was subject to fiduciary constraint. As the fiduciary law developed, concrete rules became substituted for courts' exercise of discretion based on broad principles.

Fiduciary obligations of corporate directors provide a good example of this process in fiduciary law. The rules, however, cannot foresee all possible violations in every fiduciary context. Therefore, there is still room in fiduciary law which requires discretion-based judgment. This makes the fiduciary concept one of the most elusive concepts in the law.[55]

3. Fiduciary Duties

A fiduciary relationship deserves a special protection because of the trust and dependency involved in it.[56] The confidence placed by one party in the other triggers the risk of possible abuses by fiduciaries. Therefore, fiduciary duties developed through common law as a judicial assurance to such risks to beneficiaries. Although not to the same extent, all fiduciaries are generally subject to fiduciary duties of loyalty and care.[57] The main duties of loyalty and care are aimed at deterring fiduciaries and protecting beneficiaries from wrongdoing. The first risk is the possible temptation of fiduciaries to abuse the entrustment, and the second risk is possible faulty performance of fiduciaries.[58] The duty of loyalty is designed to ensure that fiduciaries act in the best interest of beneficiaries, and avoid acts that put their interests in conflict with beneficiaries'.[59] The duty of care requires fiduciaries to execute their services, and execute them with prudence, attention, and proficiency.[60]

The duty of loyalty prohibits fiduciaries from misappropriating or misusing entrusted property or power.[61] Loyalty entails the exclusive benefit principle in favor of the beneficiary and prophylactic prohibition on self-dealing by fiduciary.[62] It requires that fiduciaries act for the sole benefit of the entrustors and forbids them from acting in conflict of interest against the interest of beneficiaries. The notion is that the fiduciary should act only as the beneficiary would

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[55] Demott, *supra* note 8, at 879.
[56] Lisa Fairfax, *Trust, the Federal Sentencing Guidelines, and Lessons from Fiduciary Law*, 51 CATH. U. L. REV. 1025, 1029 (2002).
[57] FRANKEL, *supra* note 29, at 106.
[58] *Id.*
[59] Demott, *supra* note 8, at 882.
[60] FRANKEL, *supra* note 29, at 169.
[61] *Id*. at 108.
[62] Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 601 (1997).

act for himself and as between the fiduciary's interest and the beneficiary's interest the fiduciary should serve only the latter.[63]

After all, if the entrusted property or power does not belong to the fiduciaries, it follows that the fiduciaries may not benefit from it, except upon the consent of the beneficiary or the source of his authority or the law.[64] To assure such exclusive service, the fiduciary is to refrain from engaging in any transaction with the beneficiary's assets which he might either gain for himself or harm the beneficiary.[65] The duty of loyalty prohibits actions even though they are not necessarily injurious to beneficiaries.[66] Thus, loyalty is in place to "dampen the fiduciaries' temptations to misappropriate entrusted property or power, or to justify benefitting themselves, and establish a continuous reminder that entrusted property and power do not belong to [them]."[67]

On the other hand, the duty of care is related to the quality of the services that fiduciaries offer and perform.[68] It requires that fiduciaries devote a reasonable amount of time and attention to their services. They should also possess and use the expert skills they purport to possess.[69] The duty of care focuses on the area that is left to fiduciaries' discretion in reliance on their expertise.[70] In contrast to the duty of loyalty, a violation of the duty of care is linked to lack of expertise, inattention, and negligence.[71] Nonetheless, the approach to the duty of care is less strict than the approach to the duty of loyalty because the first is closely related to discretionary power of fiduciaries.

Similarly, one can consider the duty of care to be less important than the duty of loyalty.[72] Judges and scholars usually emphasize the duty of loyalty much more than duty of care when they deal with fiduciary context generally. The duty of loyalty is related to fundamentals in a fiduciary relationship; it prohibits self-dealing and abuse of property or power, and protects the interest of the beneficiary. On the other hand, the duty of care is related to how to perform services and it contains ambiguous standards compared to the duty of loyalty.

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[63] *Id.*
[64] FRANKEL, *supra* note 29, at 108.
[65] Brudney, *supra* note 62, at 602.
[66] FRANKEL, *supra* note 29, at 108.
[67] *Id.*
[68] *Id.* at 169.
[69] *Id*. at 171.
[70] *Id*. at 169.
[71] *Id*.
[72] *Id.*

Nevertheless, there is no uniform application of fiduciary duties which fits in all fiduciary relationships. As the conditions that implicate fiduciary relationships are not identical, so change the application of fiduciary obligations. Also, the sanctions imposed upon violation of fiduciary obligations may differ.[73] The context and application of fiduciary duties are flexible because they developed in common law through analogy rather than strict principle. Judges applied trust principles in relationships similar to trust and in time that resulted in broad fiduciary principles. Thus, based on these principles, judges apply fiduciary duties case by case to the extent that they fit in a particular fiduciary relationship.

B. A Brief History the Role of Fiduciary Law in Corporations

The nature and role of corporations in the economy have changed drastically over time. Accordingly, the regulatory regime of corporations significantly evolved, particularly in the course of the nineteenth century. Strict regulatory control over corporate behavior gave way to extremely permissive corporate laws.[74] Fiduciary duties of directors followed a similar path, the demanding fiduciary regime of corporate directors ended up with virtually no fiduciary liability in the twenty-first century.

The fiduciary law of corporate directors was greatly influenced by changing characteristics of corporations. In the early twentieth century scholars and judges viewed directors as trustees.[75] This view was shaped by concerns about the concentration of private and public power in corporations, and it helped legitimate emerging powerful public corporations.[76] The mid-century notion that directors were representatives of the shareholders was informed by the ideals of democracy.[77] The courts used this notion to justify their deference to directors' decisions. The late twentieth century description of directors as agents was influenced by market ideology, and this vision helped eviscerate fiduciary duties of directors.[78]

"The first corporations, run by their proprietors and constrained by law, exercised state-granted privileges to further the public interest."[79] Under early American law, corporations could

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[73] Brudney, *supra* note 62, at 595.
[74] Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done about It*, 85 OR. L. REV. 993, 994 (2006).
[75] *Id.*
[76] Dalia T. Mitchell, *Status Bound: The Twentieth Century Evolution of Directors' Liability*, 5 N.Y.U. J. L. & BUS. 63, 65 (2009).
[77] *Id.*
[78] *Id. See supra* notes 39–43 & accompanying text. *See also infra* notes 132–40 & accompanying text.
[79] Walter Werner, *Corporation Law in Search of Its Future,* 81 COLUM. L. REV. 1611, 1612 (1981).

be formed only under a charter granted by states upon special application.[80] Each special charter specified the obligations and privileges of the particular corporation.[81] As strictly state-created entities, corporations were considered to be subject to rigid control by their creators.[82] The understanding was that corporations were artificial entities and they owed their "existence to the willingness of the state to grant its being."[83] The then-dominant concession theory of corporations held that since corporations existed under the will of the state, a corporate entity possessed only rights and privileges specifically granted to it by the state.[84] This view legitimated states' strong regulatory control over corporations through an exclusive and individualized charter system.

The board of directors was part of corporate structure at that time; however, it was not considered to be a significant body.[85] Since corporations were regulated and strictly controlled by states, directors were not expected to play a major role in their corporations. In business corporations, those who owned all or a majority of a corporation's stock managed the corporation.[86] Thus, directors, if different from the owners, served for the prestige associated with the position.[87]

In the early nineteenth century, with the growth of the American economy and rapid industrialization, the corporate form became very popular as business entities. The corporate form provided great advantages for businesses such as legal personality, the ability to centralize the management, the power to issue transferable shares, and the right to limit the liability of individuals participating in the business company.[88] Because of these important benefits and increasingly large and complex business activities, progressively more businesses sought corporate charters. As a result, legislatures could not keep up with the demand for special charters, and the inefficiency of the system became apparent.[89] Following the failure of the special charter system, states began to enact general incorporation laws.[90] General incorporation

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[80] Taylor, *supra* note 74, at 996.
[81] *Id*.
[82] *Id.*
[83] *Id.*
[84] *Id*. at 997.
[85] Mitchell, *supra* note 76, at 96.
[86] *Id.* at 69.
[87] Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 595 (2006).
[88] Taylor, *supra* note 74, at 997.
[89] *Id*. at 998.
[90] FRANKLIN A. GEVURTZ, CORPORATION LAW 19 (2nd ed. 2000).

laws repealed individualized process and regulated a standardized set of requirements to gain a corporate charter.[91]

The turn to general corporation law from special charters gradually loosened regulatory control over corporations by states. Similarly, the understanding of corporations changed in a more business friendly manner. However, during that time, corporate statutes set a number of limitations for corporations. They limited the capital which corporations could raise, the length of the corporation's existence, and the activities in which a corporation could engage.[92] Nevertheless, new developments suggested that corporations were essential to promote business and corporate law should "enable business men to act, not police their action."[93] This desire led states to further liberalization of corporate regulatory law. Accordingly, states turned to enabling corporate statutes which reduced state control to a minimum so that entrepreneurs could operate freely.[94] States were no longer imposing any conditions on access to the corporate form or any limits on corporations, and they could structure their affairs under their articles or bylaws.[95]

The board of directors emerged as an important institution with the development of modern public corporation in the late nineteenth century.[96] As giant public corporations began to emerge, the status of the board attracted broader public attention in the context of corporate power and its potential abuse.[97] During that time, despite the growing dispersal of share ownership, corporate control was concentrated in the hands of investment bankers, controlling shareholders, and top management.[98] Jurists turned their focus on directors and wanted them "to act as trustees, subject to heightened duties and liabilities," to prevent the control group from harming "both the community at large and the individual shareholder through its participation in management or through market manipulation."[99] Vesting directors with public power and trust also helped legitimate emerging large public corporations in society.[100] Judges referred to

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91 Taylor, *supra* note 74, at 998.
92 GEVURTZ, *supra* note 90, at 20.
93 Taylor, *supra* note 74, at 1001.
94 GEVURTZ, *supra* note 90, at 21.
95 *Id.*
96 Mitchell, *supra* note 76, at 66.
97 *Id.*
98 *Id* at 92.
99 *Id.*
100 *Id* at 66.

directors as trustees in a fiduciary context and required them to comply with high fiduciary standards.[101]

Indeed, the board of directors and its fiduciary status played an important role in the transition from strict regulatory regime to permissive corporation laws. On one hand, demands of growing businesses resisted close control over corporations by public authorities. On the other hand, the corporation expanded into a huge concentrate of resources,[102] because it was legally and practically able to collect large amounts of public capital. Its operation crucially affected society, and there was a need of a control mechanism. At that point, non-statutory fiduciary law was considered to fill the gap in absence of statutory restraints on corporations. Regulators were willing to permit more flexibility in statutory corporate regulations as long as the common law required corporate behavior to be monitored by strict fiduciary duties.[103]

Common law of fiduciary duties could limit the ability of directors to abuse the flexibility of enabling statutes at the expense of shareholders.[104] Managers could move freely when they managed their corporations, "but their movements would be held in check, not by substantive regulation, but by certain minimum standards imposed by fiduciary duties."[105] The behavior of corporate management was subject to ex-post judicial review measured by fiduciary principles.[106] Thus, the loosening of regulatory control over corporate boards was justified by the view that "fiduciary duty doctrine would provide sufficient disciplining incentive" on corporate boards and executive management.[107] Especially, duties of loyalty and care were recognized as important control mechanisms over a corporation's board of directors.[108]

Meanwhile, the changing nature of corporations led scholars to reconsider the theoretical conceptualization of corporate form. Aggregation theory replaced concession doctrine since corporations were no longer dominated by state authorities.[109] Aggregation theory derived from partnership law and viewed a corporation as an aggregation of individuals.[110] The state's role in corporations was not important because shareholders were the main element of corporate

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[101] *See generally* Taylor, *supra* note 74.
[102] Werner, *supra* note 79, at 1612.
[103] Taylor, *supra* note 74, at 994.
[104] Strine, *supra* note 10, at 501.
[105] Taylor, *supra* note 74, at 1006.
[106] Allen et al., *supra* note 18, at 1289.
[107] Taylor, *supra* note 74, at 995.
[108] *Id.* at 994.
[109] *Id*. at 999.
[110] *Id.*

aggregates, and they could monitor corporate behavior effectively.[111] However, aggregation conceptualization was short lived, because partnership analogy was unable to explain complex corporate mechanisms. In practice, contrary to the theory, shareholders were not exercising control over corporate affairs. The management and control of corporations were completely ceded to top management.[112]

After codification of enabling statutes, corporate conceptualization shifted from aggregation to the real entity theory. The real entity notion held that a corporation had an identity and attributes independent from its shareholders or other constituencies.[113] In the legal perspective, corporations existed just like individuals, and they were subject to the sovereign state in that manner.[114] The real entity theory supported the notion that described directors as trustees. Both concepts were grounded in the understanding that corporations were powerful, perhaps even sovereign, entities.[115] As trustees for the community in these large and powerful organizations, the boards of directors reflected the public nature of corporations.[116] Real entity doctrine prevailed until the mid-twentieth century along with the concept which characterized directors as trustees.

By the mid-twentieth century, statutorily-built corporate governance structures proved to be inefficient.[117] Despite legislatively imposed checks and balances to prevent the rise of overpowered corporate executive authority, "paramount executive authority emerged."[118] Insider professional management became more powerful and dominated the board and the affairs of the corporation. In the meantime, the number of individual shareholders had drastically increased, and the concentrated ownership structure in corporations changed into dispersed ownership.[119] Therefore, shareholders were not in a position to affect or control corporate affairs. In this context, legal literature focused more on the relationship between shareholders, managers, and directors rather than corporate power. The purpose of the board of directors, as representatives of

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111 *Id.*
112 *Id.*
113 *Id.*
114 *Id.* at 1001.
115 Mitchell, *supra* note 76, at 66.
116 *Id*. at 70.
117 *Id.*
118 Mitchell, *supra* note 76, at 70 (quoting James A. Ward, *Power and Accountability on the Pennsylvania Railroad, 1846-1878*, 49 BUS. HIST. REV. 37, 38 (1975)).
119 Mitchell, *supra* note 76, at 108.

shareholders, was to protect shareholders from excessively powerful management and to mediate conflicts between these two.[120]

Understanding directors as representatives of shareholders, associated with other changes in the corporate arena, implied a less demanding fiduciary regime for directors. In the 1930s, the federal securities regulations emerged as an important constraint on management. The Securities Act of 1933 and the 1934 Securities and Exchange Act imposed mandatory disclosure requirements on corporations to ensure that shareholders received adequate information about the business and affairs of corporations. The enactment of securities regulations helped to ease the strict fiduciary notion since they employed a comprehensive disclosure mechanism on corporate actions. In addition, shareholders began to use derivative suits more aggressively to interfere in corporate actions.[121] The courts, in response, emphasized the business judgment rule in a way that gave excessive deference to directors' discretion.[122] Thus, the business judgment rule was expanded at the expense of fiduciary liability to prevent growing shareholder derivative suits and perhaps due to the belief that securities regulations granted shareholders adequate protection.[123]

Mainstream legal literature continued to evolve in a director-friendly manner in the late twentieth century. The board of directors was not sufficiently involved in managing the affairs and business of the corporations "to perform the tasks traditionally assigned to it."[124] Therefore, academic discussions focused on the function of directors in corporations, and the monitoring concept emerged. Under the monitoring concept, the board was not there to manage the corporation. Rather, the board's task was to determine general and financial policies under which business was conducted and to supervise executives who managed the corporation. The monitoring board concept worked in tandem with the notion that the board of directors should be independent from top executive management to perform the oversight duty effectively. Accordingly, the notion of director independency became popular in large publicly-held

[120] *Id.* at 109.
[121] *Id.* at 67.
[122] *Id*.
[123] *Id*. at 118. For example, Delaware courts collapsed the duty of care into business judgment rule and changed the standard of review from negligence to gross negligence. *Id*. at 68.
[124] Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375, 376 (1975).

corporations, and the monitoring board was composed of a majority of independent or outside directors.[125]

Substantial changes in corporate conceptualization accompanied the monitoring board in the 1980s.[126] The focus of scholarly debates moved from concerns of corporate hierarchies to economic aspects of corporations such as cost reduction and profit maximization issues.[127] The "nexus of contract" or "contractarian" theory of the corporation dominated legal literature, which is still the prevailing theory today. Under this theory, a corporation is not a person or entity; it is a set of contractual relationships among participants in the corporate enterprise.[128] "[T]he firm is not a thing but rather a nexus of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm."[129] Shareholders, directors, officers or other participants in the corporation do not have any special status or power, rather each participant assumes only those rights and obligations afforded it by contract.[130] State law requirements are not external regulations over corporations, but they merely provide standard default rules so that participants do not need to negotiate certain basic points every time they contract.[131]

The contractarian theory holds that the management of corporations has no special status, but it is only one of many bargaining units.[132] There is no need of external legal constraints on top officers or directors, because efficient markets provide an adequate control mechanism on corporate management.[133] As prevailing theory recognized no internal power or hierarchy among corporate constituencies, the view that characterized directors as representatives of the shareholders was not common anymore. Legal environments turned their focus to the law of contracts and agency to tailor the status of directors in accordance with the new concept of the board and corporate theory. Hence, the idea that "directors were [mere private] agents of shareholders" gained prominence.[134]

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[125] Mitchell, *supra* note 76, at 68.
[126] Taylor, *supra* note 74, at 1003.
[127] Mitchell, *supra* note 76, at 125.
[128] STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 28 (2008).
[129] *Id.*
[130] Taylor, *supra* note 74, at 1003.
[131] *Id*. at 1004.
[132] *Id.* at 1003.
[133] *Id*. at 1004.
[134] Mitchell, *supra* note 76, at 128. *See also* Hecker, *supra* note 26, at 925 (stating that although the board of directors was conceptualized as agents in the literature, neither the board of directors nor an individual director is technically agent of corporation).

The agency status of directors, which was suggested by understandings of market-based corporate theory, developed in parallel to the monitoring board, which was composed of a majority of outside independent directors.[135] The monitoring board's main task was to monitor the executives, and "independent directors were best suited for this task." [136] Not surprisingly, the characterization of the monitoring board as the agent of shareholders suggested very limited fiduciary liability, if any, for directors. The presence of independent directors substantiated minimal fiduciary liability regime for the whole board, including insider directors. The contractarian theory helped legitimize minimizing director liability by suggesting that there is no need for regulatory control over management since "discipline of corporate management comes from the policing feature of the market."[137] The last decades of the twentieth century witnessed a set of events in the corporate arena that resulted in virtually no fiduciary liability of directors.[138] While the duty of loyalty of corporate directors is confined to mere procedural steps, monetary liability for breach of duty of care is totally eliminated by exculpatory provisions.[139] Thus, "modernization of corporate theory caused the death of fiduciary duty."[140]

C. The Role of the Board of Directors in Corporations

1. The Fiduciary Nature of Directors

In a fiduciary relationship, the fiduciary is in charge of acting primarily for the interest of the beneficiary.[141] It implies discretion and authority on the fiduciary's part, and dependency and reliance on the beneficiary's part.[142] Corporate relationships truly reflect these essential characteristics of fiduciary relationships. As fiduciaries, "directors are entrusted with power to use in the interest of others."[143] Under modern corporate statutes, the board of directors is vested with discretionary authority to manage or monitor the affairs and business of the corporation.[144] The board elects officers to delegate managerial authority to them both formally and informally.

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[135] Mitchell, *supra* note 76, at 68. An independent director is a person who is not an executive officer or employee of the corporation, and who does not have a material or pecuniary relationship with the corporation or related persons.
[136] *Id*. at 123.
[137] Taylor, *supra* note 74, at 1004.
[138] *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (In *Van Gorkom*, the court held the board of directors responsible for a breach of the duty of care, and shortly thereafter Delaware enacted exculpatory provisions.).
[139] *See* DEL. CODE. ANN. tit. 8, §§ 144(a)(1), (2), 102(b)(7) (2011).
[140] Taylor, *supra* note 74, at 1006.
[141] *Madeira*, 640 P. 2d at 1241.
[142] Hecker, *supra* note 26, at 925.
[143] Demott, *supra* note 8, at 881.
[144] *See, e.g.,* DEL. CODE ANN. tit. 8, § 141(a).

The executive officers manage the corporation under the oversight of the board for the benefit of shareholders. Thus, corporate directors and officers "stand in a fiduciary relation to the corporation and its stockholders."[145]

In corporate law, directors have long been recognized to be bound by fiduciary obligations. In an old English law case, the court formulated fiduciary principles in corporate context, stating that, by accepting a managerial role, "a person is obliged to execute it with fidelity and reasonable diligence."[146] In early corporate law in the United States, fiduciary status of corporate directors was recognized as an analogy of trust. Although they are not technically trustees, directors occupy a position of trust and confidence.[147] In corporations, shareholders invest their money with an expectation of higher return. Once they invest, they lose all control over their investment except the possibility of selling it on the market at market value.[148] Restricting the power of directors or maintaining the control by shareholders is unrealistic because of a number of factors such as dispersed ownership structure of corporations, infinite array of investment opportunities for corporations, risky nature of businesses, and the required high level of business skills for officers to manage corporations.[149] So why would anybody

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[145] Guth v. Loft, Inc, 5 A.2d 503, at 510 (Del 1939).
[146] Charitable Corp. v. Sutton, (1742) 26 Eng. Rep. 642, 645 (Ch.).
[147] *Id*.
[148] *See* Mitchell, *supra* note 27, at 431 ("This option is sometimes limited or unavailable because of fiduciary misconduct's potential effect on value.").
[149] It should be noted that in the twenty-first century shareholder activism by institutional investors has led to increasing shareholder influence over publicly-held corporations' management. Institutional investors, such as mutual funds, insurance companies, and pension funds, hold large blocks of shares of a corporation, and they may have influence in the management of a corporation by exercising their voting rights. Furthermore, institutional investors increasingly engage in activism to influence corporate governance practices. This activism includes coordination efforts to enhance shareholder voting power in publicly-held corporations. The most significant effort is the majority vote movement; that is, changing the director election standard from plurality of those voting to a majority of those voting. This has been facilitated by amendments to the Delaware General Corporation Law (DGCL) in 2006. The amendments are designed to make it easier for shareholders to require majority voting in the election of a corporation's directors. Specifically, the amendments enable shareholders to adopt an irrevocable change of bylaws regarding the election of directors and provide for an irrevocable resignation upon the failure of a director to receive a specified vote for reelection. Under the DGCL, the default standard for the election of directors is plurality. *See* DEL. CODE ANN. tit. 8, §216(3). Section 216 also allows a corporation's certificate of incorporation or bylaw to include a provision altering the plurality standard. Under DGCL, shareholders of a corporation can adopt a bylaw amendment without board approval. *See* DEL. CODE ANN. tit. 8, §109(a). Section 216 provides that "[a] bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors." DEL. CODE ANN. tit. 8, §216. Thus, it is possible for stockholders of a Delaware corporation to adopt a majority voting standard for the election of directors against the will of a board of directors. Second amendment to DGCL makes a director resignation agreement (e.g., an agreement calling for a director who is reelected by a plurality of votes, but not a majority of shares voting, to resign from the board) enforceable. Section 141(b) of DGCL provides that a director resignation may be made effective upon the happening of an event or events and that a resignation upon the failure of achieving

invest her money in a corporation despite the fact that she has no control of it? Presumably, the answer is that shareholders trust that the board of directors and executive manegement of the corporation will act in their interest to maximize the return of their investment. Shareholders expect that "corporate fiduciaries will use their funds to provide a desirable return at an acceptable level of risk and thus are willing to put their money in a corporation."[150]

The trust and confidence employed by shareholders in corporate directors require fiduciary limitations on corporate boards. The courts of equity imposed equity principles on director conduct to assure that they do not abuse their position of trust and confidence. Thus, corporate directors owe fiduciary duties of care and loyalty to the corporations they serve and their shareholders.[151] Directors must use their discretionary authority properly to promote the interests of shareholders and the corporation. Fiduciary duties ensure a reasonable and lawful exercise of statutorily assigned powers of directors. As the Delaware Supreme Court expressed in 1939, fiduciary status demands a corporate director to affirmatively protect the interests of the corporation and to refrain from doing anything that would cause injury to the corporation.[152]

2. Corporate Structure and the Supremacy of Directors

Corporations are artificial entities which exist by virtue of statutes. Corporate law defines the relative rights and duties of participants in the entity. It seeks to set the optimal balance of power among directors, shareholders, officers and other constituencies such as creditors and employees, and determines the process by which parties exercise their authority. In a typical corporation, the owners of the corporation (the shareholders) elect a body of individuals (the

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a specified vote may provide that it is irrevocable. *See* DEL. CODE ANN. tit. 8, § 141(b) ("A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable."). Institutional shareholders increasingly push large publicly-held corporations to put such arrangements in place in order to exercise a greater influence in corporate governance. Institutional shareholder activism also led to important legal developments in the federal arena. In 2010, the Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 951 of this Act mandates advisory shareholder vote on the prior year's compensation of a publicly-traded corporation's top five executives (say on pay). *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010) (adding new section 14A to the Securities Exchange Act of 1934) (codified at 15 U.S.C. § 78n–1). Say on pay vote is advisory, and it is not binding upon the corporation. These and other developments on state and federal levels increase shareholder influence in corporate governance; however, they do not alter the fundamental corporate law principle that the business and affairs of a corporation is managed by or under its board of directors. These developments do not entitle shareholders to participate in a corporation's management. Therefore, the main characteristic of the corporation form, separation of legal control from beneficial ownership, and the fiduciary status of directors remain intact. *See infra* notes 153–59.

[150] *See* Mitchell, *supra* note 27, at 431.
[151] Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998).
[152] *Loft*, 5 A.2d at 510.

board of directors) to be in charge of the corporation. The board of directors makes general policy decisions and elects executive officers. These officers implement decisions of the board and deal with day-to-day operational management of the corporation under the oversight of the board.

The separation between ownership and control is the most distinctive characteristic of the corporate form. All corporation statutes build institutional governance structure of corporations upon this separation.[153] As the owners of the corporation,[154] shareholders are not entitled to participate in the management of the corporation; rather, their rights are limited to elect the board of directors and to approve or disapprove certain corporate actions.[155] The board of directors and executive officers are responsible for the management of the corporation. The body of shareholders has no control over the management decisions or corporate affairs.

One might think that shareholders have an indirect control over the corporation through their rights to elect directors and to vote on certain corporate actions.[156] However, a number of regulatory and practical impediments prevent shareholders from exercising any meaningful control over the corporation by their existing rights.[157] Additionally, the election process of members of the board insulates directors from shareholder pressure.[158] As prominent corporate scholars Berle and Means put it, a shareholder "who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely recipient of the wages of capital."[159]

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153 BAINBRIDGE, *supra* note, 128, at 4.
154 Whether shareholders are considered as the owners of the corporation is a controversial issue. *See* Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1998). Eisenberg states that the relation between shareholders and corporation is ownership because shareholdership carries most of the incidents of ownership except direct control. On the contrary, contractarian theory claims that shareholders do not own the corporation; rather they only own the residual claim on the corporation's assets and earnings. *See* BAINBRIDGE, *supra* note 128, at 32.
155 *E.g.,* amendment of articles, mergers, sales of substantially all assets, and dissolving the corporation.
156 Shareholders' right to vote is limited to approve or disapprove various transactions initiated by the board; shareholders cannot initiate or make the board to engage in such a transaction.
157 *But see supra* note 149 (examining institutional shareholder activism and legal changes on state and federal level that enhance shareholder voting power in publicly-held corporations).
158 *See* DEL. CODE ANN. tit. 8, §216(3). Under section 216(3), the default standard for the election of directors is plurality, not majority. *See supra* note 149 (examining the majority vote requirement). *See also* DEL. CODE ANN. tit. 8, §112 (By adding a provision to bylaws, shareholders can put their director nominees in corporate proxy solicitation materials for the election of directors.).
159 ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 5 (rev. ed. 1968).

Under all corporate statutes, the cardinal principle is that the business and affairs of a corporation are managed by or under the direction of its board of directors.[160] Since the board is not able to deal with the daily business of the corporation, the rule is formulated as "by or under the direction of the board" so that the board can delegate its powers to employees of the corporation, while it retains ultimate responsibility. The board of directors is not subject to the control of shareholders or other corporate constituencies, because the board obtains its authority directly from corporate statute. Directors are not required to act in accordance with the wishes of shareholders.[161] To the contrary, they should use their own business judgment in the best interest of corporation and its shareholders, and they can take actions that they believe in the best interest of the corporation and shareholders, even though shareholders do not agree with them regarding those actions.[162] The courts have recognized the boards' statutory power to manage the corporation by consistently rejecting shareholders' attempts to seek judicial intervention to the board actions they did not agree with.

In *People Ex. Rel. Manice v. Powell,* the court emphasized that the board of directors is not in a position of agency towards corporation, and "the powers of the board of directors are, in very important sense, original and undelegated."[163] In case law, the business judgment rule was created "to protect and promote the full and free exercise of the managerial power granted to directors."[164] Under this rule, the courts will not review honest and informed decisions of disinterested directors. The business judgment rule and other rules related to shareholder litigation such as director demand requirement preclude shareholders from using litigation as an oversight mechanism over a corporation's board of directors. Thus, "the board's freedom to exercise business judgment is virtually unconstrained."[165]

3. Decision-Making and Monitoring/Oversight Functions

Under the traditional model of corporate law, the function of the board was to manage the business and affairs of the corporation. Over time, however, the size of corporations and their businesses have grown tremendously, and it has become clear that, in practice, the boards are

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[160] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a).
[161] 1 STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 216 (6th ed. 2009).
[162] *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 655 (Del. Ch. 2008).
[163] People ex rel. Manice v. Powell, 201 N.Y. 194, 200 (N.Y. 1911) (citation ommitted).
[164] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).
[165] BAINBRIDGE, *supra* note 128, at 12.

unable to perform management functions in the traditional sense.[166] Therefore, the conceptualization and regulatory regime of the board of directors evolved to embrace the practice. Under the modern corporate law, "the board still plays a central role in the corporation,"[167] but most of the powers legally vested in the board are actually being performed by executive officers. In modern practice, executive officers perform most part of policy-making and management functions, and CEOs are the leading figures in corporations. The primary function of the board is not to manage the business of a corporation, but rather to monitor and oversee the conduct of the corporation's business.[168] Corporate statutes reflect this practical reality in the norm, "[t]he business and affairs of every corporation shall be managed by or under the direction of a board of directors."[169]

This reality is also acknowledged explicitly in section 3.01 of the ALI's Principles of Corporate Governance. Under section 3.01, subject to the functions and powers of the board of directors, the management of the business of a publicly held corporation should be conducted by or under the supervision of such principal senior executives as are designated by the board.[170] Section 3.02 states that the board should oversee the conduct of corporation's business and performance of its managers and lists other major corporate functions that the board should fulfill.[171] The board should actively perform decision-making authority on corporate actions that the board is obliged to or chooses to act upon, and should monitor the performance of the delegates in managing the business to the extent of the delegation of the board's authority.[172]

Thus, directors' role in corporations includes two basic functions: decision-making and oversight.[173] The decision-making function refers to actions taken at a point in time; the oversight function involves ongoing monitoring of the business and affairs of the corporation over a period of time.[174] The decision-making function generally involves taking actions with

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[166] MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 140–44 (reprt. 2006) (examining research concerning board meetings and concluding that the time and information constraints significantly reduce a board's meaningful involvement in managing a corporation's business or making business policy).
[167] EISENBERG & COX, *supra* note 1, at 328.
[168] Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 439 (1994).
[169] DEL. CODE. ANN. tit. 8, § 141(a).
[170] PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.01 (1994).
[171] PRINCIPLES OF CORPORATE GOVERNANCE § 3.02.
[172] Hecker, *supra* note 26, at 937.
[173] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 11.
[174] 1 RADIN, *supra* note 161, at 443.

respect to specific corporate matters and formulating general corporate policy and business goals.[175] Directors must select and compensate principal senior executive officers, and evaluate their performance and replace them when necessary. They must review and approve the corporation's financial objectives, general corporate policies, major corporate plans and actions, and appropriate auditing and accounting principles and practices regarding financial statements.[176] When they perform their decision-making function on corporate matters, directors should employ an informative and deliberative process. As the Delaware Chancery Court observed, however, "[m]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention."[177] While they retain the ultimate responsibility, directors delegate management of daily business operations to corporate officers. Therefore, directors must oversee corporate officers to secure the quality and integrity of the operation of the business.[178]

The oversight function of the board does not require an active supervision or day-to-day scrutiny of corporate business and affairs; rather, it implies a general observation and oversight of the corporation.[179] It requires that directors employ an appropriate monitoring system to ensure adequate information flow and evaluate the information received through monitoring systems, and take action if necessary. In particular, directors should pay "attention to corporate business performance, plans and strategies, risk assessment and management, compliance with legal obligations and corporate policies, and the quality of financial and other reports to shareholders, as well as attention to matters suggesting a need for inquiry or investigation."[180] In other words, they generally need to be aware of major corporate affairs and be ready to step in when necessary.

To effectively perform its decision-making and oversight functions, the board may designate one or more committees to exercise the powers and authority of the board on certain corporate matters. Indeed, the modern corporate law requires the boards of directors to have committees, and now it is a prevalent practice that the boards of publicly held corporations have

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[175] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 11.
[176] PRINCIPLES OF CORPORATE GOVERNANCE § 3.02(a).
[177] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968 (Del. Ch. 1996) (quoted in Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006)).
[178] 1 RADIN, *supra* note 161, at 444.
[179] PRINCIPLES OF CORPORATE GOVERNANCE § 3.02 cmt. d.
[180] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 11.

certain committees. Under the rules of New York Stock Exchange and NASDAQ, listed corporations should have audit, nominating/corporate governance, and compensation committees in their boards.[181] The board committees fulfill the duties specified in the corporate regulations and in the board resolution or by-laws. Directors should exercise reasonable care when they select the members of committees, and they are entitled to rely on information, statements, and reports submitted by committees.[182]

Additionally, in modern corporate practice, the key function of the board of directors is to monitor executives and other corporate officers,[183] and therefore, directors who are independent from top executive management are best-suited for the task of monitoring.[184] Under the rules of New York Stock Exchange and NASDAQ, the listed corporations should have boards whose majority is composed of independent directors that do not have any material relationship with the corporation.[185] The rules also require that nominating/corporate governance, audit, and compensation committees—or any committee to which these committees' duties are delegated—are composed solely of independent directors.[186]

The regulations regarding board committees and independence of directors aim to enhance the quality of corporate governance. The fiduciary duties of directors, likewise, are in place to ensure that directors perform decision-making and oversight function properly and in the best interest of shareholders. Fiduciary principles do not contain substantial regulations; rather they provide common standards applicable to director behavior in general. The duty of care, for example, requires directors to employ an informative and deliberative process when they make decisions on corporate matters and when they perform oversight function over corporation. The next chapter examines the duty of care of corporate directors in the decision-making and oversight contexts.

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[181] NYSE, LISTED COMPANY MANUAL §§ 303A.04, A.05, A.06 (2013), available at http://nysemanual.nyse.com/lcm/ [hereinafter NYSE]; NASDAQ, THE QUALIFICATION, LISTING AND DELISTING OF COMPANIES RULE IM-5605-(b)(2)(A), (d)(2)(A) (2013), available at http://nasdaq.cchwallstreet.com/ [hereinafter NASDAQ].
[182] DEL. CODE. ANN. tit. 8, §141(c)(2), (3)(e).
[183] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 2.
[184] Mitchell, *supra* note 76, at 132.
[185] NYSE, § 303A.01; NASDAQ, RULE IM–5605–1.
[186] NYSE, §§ 303A.04(a), A.05(a), A.07(a).

CHAPTER III. THE DUTY OF CARE

A. The Difference between a Standard of Care and a Standard of Review (In General)

A standard of conduct describes how a person should conduct a given activity or perform a given duty.[187] A standard of review describes the test a court should apply in reviewing a person's conduct to determine whether to impose liability.[188] In most areas of law, standards of conduct and standards of review are the same. For example, the standard of conduct with which an automobile driver should comply is that he or she should drive carefully, and the standard of review when a court determines whether a driver is liable in an accident is whether he drove carefully.[189] In corporate law, however, those two standards often diverge.[190] The duty of care, for example, has been a major area of corporate law that involves diverse standards of conduct and review.[191] Directors are under a duty to comply with the standard of care, but courts apply different standards in reviewing director conduct to determine whether they fulfilled their fiduciary duty of care.

The duty of care imposes a strict standard of care on corporate directors, but applicable standards of review for the performance of this duty are lenient. The standard of care requires directors to act reasonably when they take action on corporate matters that do not involve self-interest. In the abstract sense, the concept of "care" evokes a tort-law/negligence-based analysis in determining whether the duty of care has been properly performed.[192] However, the courts employ a quite different analysis in reviewing actions of corporate directors under the duty of care. The standards of review applicable to the exercise of the duty of care include multiple and complex tests.[193] First, the court will review a director decision under the protective business judgment rule.[194] The business judgment rule shields directors from liability by providing a presumption that directors act in accordance with their fiduciary duties. The burden is on a

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[187] Eisenberg, *supra* note 168, at 437.
[188] *Id.*
[189] *Id*. (footnote omitted).
[190] Allen, Jacobs & Strine, *supra* note 18, at 1296.
[191] The duty of loyalty of corporate directors also includes different standards of conduct and review. Under the duty of loyalty, directors are required to deal fairly with the corporation when they engage in a self-interested transaction with the corporation. If the transaction is approved by the majority of disinterested directors or shareholders, however, the transaction will be reviewed under protective business judgment rule instead of strict entire fairness standard. *See infra* Chapter IV.A.2 (discussing the duty of loyalty and interested director transactions).
[192] MODEL BUS. CORP. ACT ANN. § 8.31 Ofcl. cmt. (2011).
[193] *See* Eisenberg, *supra* note 168, at 462 ("The standards of conduct include relatively simple rules that address corporate directors and officers, whereas the standards of review include complex rules that address judges.").
[194] *See infra* Chapter III.C.1. (discussing the business judgment rule and its effects).

plaintiff to rebut the business judgment rule presumption. If the plaintiff is unable to rebut the rule's presumption, the directors' decision will be subject to an exceptionally limited review of rationality (waste). Accordingly, if the business judgment rule applies, directors will not be held liable for a decision, even if the decision is not reasonable, as long as they act rationally.[195]

The distinction between standards of conduct and review is predicated on important policy and fairness reasons.[196] While the standard of care defines the desirable conduct that directors are generally expected to exercise, "it is fundamentally fair to review their conduct on a less demanding level"[197] because directors often have to act with limited and incomplete information, they do not have control over the business environment that affects their decision, and they must take risks. A standard of review of ordinary care does not fit the risky nature of complex business decisions.[198] The strict standard of ordinary care primarily addresses paradigm negligence cases that involve simple judgments such as automobile accidents. In those cases, typically, there is only one reasonable decision that can be made, and decisions with bad outcomes are inevitably bad decisions.[199] For example, if an automobile driver makes a mistake in judgment as to speed or distance injuring a pedestrian, he will likely be responsible for damages.[200] In contrast, in cases involving complex judgments that must be made on incomplete information and include risk, there is typically a range of decisions that are reasonable.[201] Where a range of decisions are reasonable, it is often difficult, under a hindsight review, to sort out

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[195] Allen, Jacobs & Strine, *supra* note 18, at 1296.
[196] *See infra* Part C.3. (examining policy reasons behind the business judgment rule).
[197] First Union Corp. v. Suntrust Banks, Inc., 2001 NCBC LEXIS 7, at *25 (N.C. Super. Ct. Aug. 10, 2001).
[198] Former Delaware Justice Quillen explained this point as follows:

> There is a right-wrong aspect of fault in negligence law, a law which has as its prime frame of reference automobile accidents, that simply is inapplicable to business risk-taking. In addition, there is a natural reluctance to define in terms of aggravated negligence the standard of behavior which insulates fiduciaries from liability to their beneficiaries. The basic problem is in the negligence concept of an objective standard-the care of the reasonably prudent man. This pattern, designed for personal injury litigation, simply does not fit into the business director context. Ideally, business directors are chosen not for ordinary prudence but for unusually wise risk taking. It is just hard to place the decision to build the Edsel or the decision to refinance Chrysler on the scale that measures the behavior of the ordinarily prudent man, even the ordinarily prudent business director. Business directors are chosen to make their peculiar individual judgments.

William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465, 499 (1985).
[199] Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 961 (1989).
[200] Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982), *cert. denied,* 460 U.S. 1051 (1983).
[201] *Id.*

decisions that had bad outcomes from bad decisions.[202] If directors made a risky investment and it resulted in a corporate loss, for example, the decision might be considered as unreasonable simply because it turned out badly even though it looked reasonable at the time. However, it is not fair to hold directors responsible for an unsuccessful decision with the benefit of hindsight for the reason that the risk involved in the decision was realized.[203] Although directors are required to exercise appropriate care, they are not insurers of the risks of the businesses that corporations engage in.

Indeed, directors serve the best interests of shareholders when they make risky business decisions because generally higher risk is associated with higher return. A strict standard of review that imposes liability for ordinary negligence might discourage directors from taking risks and induce them to be over-cautious to avoid risk of litigation. The law, therefore, should not discourage directors from making "bold but desirable decisions,"[204] as it would "defeat one of the very purposes [for] which corporations exist."[205] Just as the law limits the liability of those who contribute their financial capital to the enterprise, it must limit the liability of those who contribute their human capital (knowledge and judgment) in order to promote creation of value or wealth.[206] Protecting directors from excessive liability is also required to attract competent people to serve as directors.[207] Lax standards of review give directors greater freedom to make risky decisions without fear of personal liability.[208] For example, a director who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will not be liable for damages suffered by the corporation.[209] Liability will be imposed on directors "only if there is a clear variance between the conduct required by law and actual director conduct."[210] Thus, although directors are required to act in accordance with conduct rules, lenient standards of

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[202] *Id.*
[203] MODEL BUS. CORP. ACT ANN. §8.31 Ofcl. cmt.
[204] Eisenberg, *supra* note 199, at 964.
[205] *First Union Corp*., 2001 NCBC LEXIS 7 at *26.
[206] *Id.* at *25.
[207] *Id.*
[208] William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 454 (2002).
[209] *Joy,* 692 F.2d at 885; *See also* MODEL BUS. CORP. ACT ANN. §8.31 Ofcl. cmt. ("[A]s a general rule, a director is not exposed to personal liability for injury or damage caused an unwise decision.").
[210] Eisenberg, *supra* note 168, at 465.

review give directors a certain margin which is essential to manage complex and large corporations.[211]

One might think that a standard of conduct has no legal or practical importance if the conduct is reviewed under different standard.[212] One commentator, for example, undermined the legal aspect of the standard of care by labeling the business judgment rule standard of review as the "de facto standard of conduct" of the duty of care, and stated that under the business judgment rule directors are required to exercise only "slight care" rather than due care.[213] Professor Eisenberg, on the other hand, argues that the standards of conduct in the fiduciary context are intended to control behavior and they have a real bite.[214] Eisenberg points out that, under certain circumstances, the lenient standard of review may not be applicable and director conduct may be reviewed under the standard of conduct.[215] For example, if directors are charged with a failure to act, the protective business judgment rule will not be available and, therefore, director inaction may be subject to review under the strict standard of conduct.[216] Thus, the standards of conduct are "safe" rules whereas standards of review are "risky" rules.[217]

With respect to the practical aspect, the standards of conduct serve as a foundation for professional practices in the market.[218] For example, legal counsel is likely to give advice to directors based on standards of conduct rather than standards of review.[219] Similarly, institutional guidelines or codes of conduct adopted by corporations that are circulated to corporate actors are usually based on the standards of conduct.[220] Thus, directors' actions will be judged by the market and shareholders based on professional practices. A director whose action does not meet the standard of conduct would likely face market-based consequences even though he might able to escape liability under lenient standards of review.

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[211] *Id.*
[212] *Id* at 463.
[213] Douglas M. Branson, *The Rule That Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 635–38 (2002).
[214] Eisenberg, *supra* note 168, at 464.
[215] *Id.*
[216] *See infra* Part D. (examining the applicable standard of review where the business judgment rule is not applicable).
[217] Eisenberg, *supra* note 168, at 464.
[218] *Id.*
[219] *Id.*
[220] *Id.*

The divergence of standards of conduct and review may sometimes leave shareholders without remedy in cases where board sloppiness results in financial harm. However, in the corporate context, utilizing standards of review that are fully consistent with standards of conduct will likely cause greater harm to shareholders generally.[221] The next section examines the duty of care of corporate directors and analyzes how the law attempts to strike a balance between the standard of care and applicable standards of review.

B. The Standard of Care: Decision-Making and Oversight

1. Delaware

Corporate directors are subject to a duty of care in connection with the discharge of their responsibilities. The duty of care requires directors to act with reasonable diligence and care in performing the important tasks of directing and monitoring corporate affairs.[222] In the decision-making context, the duty requires directors to employ a reasonable decision-making process and to make reasonable decisions.[223] In other words, it requires directors to be adequately informed on the subject matter of a decision and to make a reasonable decision upon carefully considering the relevant information. In the oversight context, the duty of care requires directors to reasonably monitor the conduct of a corporation's business and affairs, to investigate a situation that raises concern, and to take necessary action to prevent corporate wrongdoing.[224] Also, as a general rule, directors should have at least a rudimentary understanding of the business of a corporation.[225] In addition, directors are under a continuing obligation to keep informed of corporate business and affairs.[226] Directors should attend board meetings regularly, and they should maintain familiarity with the financial status of the corporation.[227] In sum, under the duty of care, directors should act responsibly and exercise an informed attention to corporate matters.

Most states' corporate statutes include provisions defining the standard of care of corporate directors.[228] In Delaware, the standard of care has been recognized and defined in court

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[221] *Id.* at 467–68.
[222] PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 Intro. n. *c.* (1994).
[223] Eisenberg, *supra* note 199, at 948.
[224] *Id.*
[225] Francis v. United Jersey Bank, 432 A.2d 814, 821–22 (N.J. 1981).
[226] *Id.*
[227] *Id.*
[228] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 Intro. n. *a*. (noting that over two-thirds of the states have statutory provisions concerning the duty of care).

decisions.[229] In 1963, the Delaware Supreme Court in *Graham v. Allis-Chalmers Manufacturing Company* adopted the ordinarily prudent person standard in the corporate fiduciary context.[230] The court held that corporate directors in discharging their functions are "bound to use the amount of care which ordinarily careful and prudent men would use in similar circumstances."[231] With the *Graham* decision, the Delaware Supreme Court explicitly recognized for the first time that directors were subject to a duty to act in a careful and prudent manner.[232]

The *Graham* decision was only the beginning of the journey of directors' standard of care in Delaware. After *Graham*, the standard of care in the decision-making context followed a difficult path, while the standard of care in the oversight context followed a relatively easy path. The ordinarily prudent person standard, rooted in tort law, is designed as one-rule-fits-all standard and, at least in theory, defines the expected conduct of directors in the decision-making context as well as in the oversight context. When it comes to injecting specific requirements into the standard of care, however, not only do the requirements differ in the decision-making and

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[229] There is no significant difference between statutory and common law formulations of the duty of care. One commentator observed: "The common law or statutory formulation of the duty of care in most states is to the same effect." George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U. L. REV. 623, 645 (1981).

[230] Graham v. Allis-Chalmers Manufacturing Company, 188 A.2d 125, 130 (Del. 1963). *See also* Briggs v. Spaulding, 141 U.S. 132 (1891). Seven decades earlier than *Graham*, the Supreme Court of the United States held that the degree of care to which directors were bound is "that which ordinarily prudent and diligent men would exercise under similar circumstances." *Id*. at 152. Also, by 1963, many states had enacted statutes defining the fiduciary duty of care of corporate directors based on an ordinary care standard. *See* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 988 (1994). Former Justice Horsey observed: "The importance of *Graham* lies not in the ultimate holding, but in the fact that not until 1963 did the Delaware Supreme Court recognize the substantial body of decisional law holding a corporate director to a fiduciary duty of care." *Id.* at 986.

[231] *Graham*, 188 A.2d at 130; *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (citing *Graham*'s duty of care formulation).

[232] Horsey, *supra* note 230, at 985–88 (examining historical progress of the duty of care in Delaware and noting that *Graham* is the first Delaware case that explicitly recognized directors' duty to act in an informed and prudent manner) Before *Graham*, Delaware cases that mentioned directors' duty to be informed and prudent were usually confined to shareholder suits asserting claim of corporate waste. *Id.* at 987 n.77. For example, four decades before *Graham*, the Delaware Chancery Court in *Allied Chemical & Dye Corp. v. Steel & Tube Co.* stated that the price in selling the assets of a company should reasonably be referable to "an honest exercise of sound business judgment" and that "a reckless indifference to the rights of others" will not be allowed to stand. 1923 Del. Ch. LEXIS 20, at *32 (Del. Ch. March 28, 1923). In Mitchell v. Highland-Western Glass Co., the Chancery Court found that directors' judgment was not "unintelligent and unadvised." 19 Del. Ch. 326, 330, 167 A. 831, 1933 Del. Ch. LEXIS 32 (Del. Ch. 1933). In Gottlieb v. Heyden Chem. Corp., the Delaware Supreme Court held that directors will not be liable for waste if the value received by the corporation "brings the court within the realm in which reasonable men, fully informed and acting in good faith, may be expected to differ." 91 A.2d 57, 58–59 (Del 1952). In Cottrell v. Pawcatuck Co., the Delaware Supreme upheld the business judgment of the directors stating that "the negotiations proceeded in an orderly manner, without undue haste, and resulted in an arms'-length bargain." 128 A.2d 225, 229 (Del. 1957).

oversight context but also a difficulty arises in determining these specific requirements. *Graham* itself presented such difficulty. *Graham*, examining directors' duty of care in the oversight context, did not provide any explication of the ordinarily prudent person standard. Moreover, following the ordinary prudent person standard, the court employed a quite lenient standard when determining the due care liability of defendant directors.[233] Thus, providing a strict standard of care on one hand and using permissive language when determining due care liability on the other hand, the *Graham* analysis was not very helpful to reify directors' standard of care in either the decision-making or oversight context.[234]

Directors' standard of care in the oversight context was revisited in *Caremark* almost four decades later after *Graham*. *Caremark*, interpreting *Graham* through legal developments in the corporate field, provided the current legal framework for the standard of care in the oversight context. Unlike the oversight context, the standard of care in the decision-making context has been addressed in a long line of cases by Delaware courts. The care in the oversight context presented more difficult issues due to policy concerns related to corporate risk-taking. Below, the progress of directors' standard of care in the decision-making context is examined in Delaware decisions. Following that, *Caremark*'s standard of care in the oversight context is visited.

a. Decision-Making

In the two decades after *Graham*, Delaware courts continued to provide no clear framework with respect to directors' standard of care.[235] The courts' heavy emphasis on the

[233] The court stated that, a director will be liable "[i]f he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." *Graham*, 188 A.2d at 130. Although the standards of conduct and review may differ in corporate fiduciary law, the court's employment of strict and lenient standards without providing any justification caused confusion. The Delaware Supreme Court in a later opinion criticized *Graham* in a footnote as follows: "The *Graham* formulation is quite confusing and unhelpful. While the opinion seems to apply a "prudent man" standard, three paragraphs later it speaks of director liability in terms of reckless conduct." Cede & Co. v. Technicolor 634 A.2d 345, 364 n.31 (Del. 1993) (citations omitted). Interestingly, however, in *Briggs*, one of the cases cited in *Graham* decision, the Supreme Court of the United States employed the same approach. The Supreme Court of the United States first stated that directors were subject to the degree of care "which ordinarily prudent and diligent men would exercise under similar circumstances," and then found no liability for the defendant directors who failed to exercise any sort of supervision over the management. *Briggs*, 141 U.S. at 152, 166.

[234] Horsey, *supra* note 230, at 988 ("the accomplishment [of *Graham*] was diminished by the tentative and almost begrudging manner in which the court embraced" the duty of care).

[235] *Id*. at 989.

protection accorded to directors under the business judgment rule[236] overshadowed directors' duty to act in an informed and prudent manner. In 1967, in *Meyerson v. El Paso Natural Gas Co*., the Delaware Chancery court stated that when reviewing a business judgment of directors "the court should not interfere absent a showing of 'gross and palpable overreaching.'"[237] In 1970, in *Getty Oil Co. v. Skelly Oil Co.,* the Delaware Supreme Court approved the *Meyerson* standard of "gross and palpable overreaching" under the business judgment rule.[238] One year later, the court in *Sinclair Oil Co. v. Levien,* after reiterating the gross and palpable overreaching standard, stated that "[a] board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose."[239] Thus, the duty of care of directors found no place for itself within Delaware business judgment rule until the early 1970s.

In a number of cases in the early 1970s, the Delaware Chancery Court required "an informed decision" for directors to be afforded the protection of the business judgment rule.[240] In 1971, the Chancery Court in *Kaplan v. Centex* found defendant directors to have lost the protection of the business judgment rule due to their failure to make an informed business judgment.[241] The court stated that "[a]pplication of the rule of necessity depends upon a showing that *informed* directors did, in fact, make a business judgment."[242] The following year, the Chancery Court in *Penn Mart Realty Co. v. Becker* stated that grossly negligent conduct of directors might constitute a breach of their fiduciary obligation to shareholders.[243] In 1974, plaintiff shareholders' claim in *Gimbel v. Signal Companies* included a failure of the board to act "with informed reasonable deliberation" in selling one of the subsidiaries of the company.[244] Upon a careful examination of the board's decision-making process, the Chancery Court

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[236] The business judgment rule is the primary standard of review in the decision-making context. It is a presumption that directors' make informed and disinterested decisions in good faith. If not rebutted, the business judgment rule protects directors from liability unless the decision amounts to waste. *See infra* Part C.1.
[237] 246 A.2d 789, 794 (Del. Ch. 1967); *see also* Warshaw v. Calhoun, 221 A.2d 487 (Del. 1966) (stating that in the absence of bad faith or gross abuse of discretion the courts will not interfere with the business judgment of directors).
[238] 267 A.2d 883, 887 (Del. 1970).
[239] 280 A.2d 717, 720 (Del. 1971).
[240] It should be noted that, before the 1970s, one Chancery Court decision explicitly required a decision to be informed to qualify for the business judgment rule protection. *See Mitchell,* 167 A. at 833.
[241] 284 A.2d 119, 124 (Del. Ch. 1971).
[242] *Id*. (emphasis added).
[243] 298 A.2d 346, 351 (Del. Ch. 1972).
[244] 316 A.2d 599, 611 (Del. Ch. 1974), *aff'd,* 316 A.2d 619 (Del. 1974).

concluded that the factors, some of which suggest imprudence, as a whole were not sufficient to pierce the business judgment standard.[245]

In spite of Chancery Court decisions that required an informed decision under the business judgment rule, the general perception in the early 1980s was that Delaware courts had refrained from imposing a duty of care limitation on directors' actions. Corporate scholars, focusing on the Delaware Supreme Court's early formulation of the business judgment rule, extensively criticized Delaware courts for failing to enforce the duty of care and thereby granting corporate directors excessive latitude.[246] For example, one commentator noted that, while the duty of care of corporate directors was "fairly straight forward and rigorous",[247] the duty of care had become "moribund" by the 1980s due to the abstention of courts to impose it.[248] Similarly, another commentator depicted the duty of care as "an endangered species" because of judicial reluctance to apply the standard of care against directors not found to be disloyal or lacking good faith.[249] In a more recent article, William Allen, a former Chancellor in Delaware, observed that

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[245] *Id*. at 615. It appears that *Gimbel* is the first Delaware case that made a clear distinction between the duty of care and waste (irrationality). After finding that directors made an informed judgment, the court examined "gross inadequacy of the price." The court stated:

> Thus, the ultimate question is not one of method but one of value. The method does not appear so bad on its face as to alter the normal legal principles which control. But hasty method which produces a dollar result which appears perhaps to be shocking is significant. On the basis of affidavits relating to value, the Court has the tentative belief that plaintiff would have a reasonable prospect of success on the merits since limited record indicates a gross disparity between the fair market value of Signal Oil … and what the Board of Directors were willing to sell the company for…

Id. See *infra* Part C.1.a. (discussing waste).

[246] The criticism was so harsh that the members of Delaware General Corporation Committee Law Delaware State Bar issued a Resource Document to defend Delaware corporation law. The Resource Document included a section of "Fiduciary Capacity and Limitations on the Business Judgment Rule" under which the committee defended the business judgment rule and its application by Delaware courts. *See Resource Document on Delaware Corporation Law*, 2 DEL. J. CORP. L. 175, 185 (1977).

[247] Dent, *supra* note 229, at 645.

[248] *Id*. at 646. The author observed: "When stated in the abstract, the duty of care seems to impose a meaningful obligation on directors and officers. In practice, however, the duty has had almost no effect on corporate governance…" *Id.* at 644–45. "[C]ourts have often described the business judgment rule without any reference to the duty of care and, more important, have often dismissed suits against directors on the ground of the business judgment rule without first inquiring whether the directors had acted reasonably and with due diligence. In some cases, courts have simply ignored a statutory 'prudent man' standard in favor of a fraud or bad faith standard under the business judgment rule." *Id.* at 647 (footnotes omitted). According to the author, the reason for the lenient treatment of the courts in the field of the duty of care was "the longstanding confusion over the proper role of the board of directors." *Id.* at 651. While statutes assigned directors to manage corporations, courts recognized that in practice boards do not, and could not be expected to, manage corporations and refused to impose a high standard of care on directors. *Id*. at 661.

[249] Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983). Like Professor Dent, Professor Cohn argued that the

"it is only a slight exaggeration to say that Delaware courts, and U.S. courts more generally, announced but did not enforce the duty of care" until mid-1980s.[250]

The perception that Delaware courts failed to enforce a duty of care and the related criticism may have stemmed from the early formulation of the business judgment rule. Delaware courts had initially developed the business judgment rule without a duty of care component.[251] Pervasive application of the rule in the decision-making context and the lack of a Delaware

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business judgment rule was a "judicially developed doctrine that has come to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality." *Id.* at 594. Cohn observed as follows:

> Although the doctrine began as an adjunct to duty of care standards designed to protect directors' decisions against hindsight evaluation when appropriate diligence had been exercised, the doctrine has enveloped the primary inquiry. This approach shifts judicial emphasis from questions of diligence to narrow, motive-oriented factors that must be satisfied in order to overcome the business judgment rule's presumption of regularity.
>
> Judicial retreat into the presumptive arena of the business judgment rule creates considerable doubt that there remains a viable shareholder action in areas other than fraud, conflict of interest, disloyalty, or the disclosure concerns of the securities laws. So common is the disposition of cases by reference to the business judgment rule that a casual observer could readily conclude that the obligation of care and the defensive presumption of the business judgment rule are mirror images of a unitary standard. It is doubtful whether there still exists a sanction for lack of care, unadulterated by self-enrichment or other opprobrious behavior. If the reasonable care standard is no longer a viable means for corporate governance, it should be removed from the common law and the statute books as a misleading shibboleth. If the standard is economically or pragmatically viable and relevant to shareholder interests, however, its preservation must be more forcefully advocated.

Id. at 594–95. Professor Cohn pointed out that the reason behind a strong business judgment rule and a weak duty of care is "judicial concern about the ambiguity of due care standards and the severity of available sanctions." *Id.*

250 William T. Allen, *Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law*, 4 CLPE RESEARCH PAPER 06/2008, at 11 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105591. In another article, Allen, joined by two co-authors, observed as follows:

> [W]e note that courts deciding Delaware corporate law cases have only recently viewed the director's duty of care as being judicially enforceable. Indeed, it is arguable that the pre- *Van Gorkom* case law reflected a judicial aversion to reviewing director action for any purpose other than identifying (and remedying) breaches of the duty of loyalty. The pre-1985 Delaware (and the American and English) tradition was highly deferential to decisions made by well-motivated corporate directors who acted without any conflicting self-interest. Judicial decisions that addressed director liability for non-self-dealing transactions suggested that the imposition of liability would require a showing akin to subjective bad faith. Even though the law of corporations continued to articulate the standard of *conduct* expected of directors in ordinary negligence terms (the 'ordinarily prudent person' standard), that normative articulation was different from the standard of judicial *review* which required a showing of far more egregious conduct to impose liability.

Allen, Jacobs & Strine, *supra* note 208, at 450–51 (emphasis in original).

251 *See supra* notes 235–39 & accompanying text. *See also* Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 639 (2000) (stating that the concept of the business judgment rule in Delaware initially developed without a direct link, functionally or doctrinally, to the director duty of due care). It should be noted that the claims the courts addressed in *Meyerson*, *Getty Oil*, and *Sinclair* were not related to the duty of care, and this may be the reason for the courts' failure emphasize the duty of care element of the business judgment rule.

Supreme Court decision that explicitly recognized a duty of care component of the rule led many to think that Delaware courts applied the business judgment rule at the expense of directors' duty of care. In the early 1980s, the business judgment rule was understood as a common law concept to preclude a judicial inquiry into directors' duty of care.[252] As one prominent member of Delaware Bar acknowledged, however, this was a misunderstanding of Delaware law, and the misunderstanding stemmed from Delaware decisions.[253]

In 1984, the Delaware Supreme Court in *Aronson v. Lewis*[254] broke new ground in terms of defining the relationship between the duty of care and the business judgment rule.[255] The court clarified the relation of the duty of care to the application of the business judgment rule by stating:

> [T]o invoke the [business judgment] rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties.[256]

With this formulation of rule, the Delaware Supreme Court explicitly recognized the duty of care component of the business judgment rule. The Delaware Supreme Court in *Aronson* invalidated the misperception that the business judgment rule immunized directors from the responsibility to exercise a duty of care. Contrary to the misperception, the court provided in a clear manner that

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[252] Horsey, *supra* note 230, at 977 ("Those who surveyed the duty of care case law in this country before the mid-eighties found an infertile field and were in nearly unanimous agreement as to their findings: the business judgment rule had been applied in such a manner as to constitute an almost per se bar to shareholder claims of directors' breach of their fiduciary duty of care.") (footnote omitted).

[253] *See* Arsht, *supra* note 15, at 93. Arsht observed as follows:

> [T]he business judgment rule is today misunderstood, at least if one is to judge from the comments of its critics, who are, in the main, distrustful of state corporate laws and are led to suggest that the *business judgment rule promises more in the way of immunity from liability than in reality it does*. The misunderstanding stems, I suspect, both from the general failure to distinguish the business judgment rule from the presumptions and limitations that surround the rule's application and from the tendency of courts to use loose language in expressing the rule. Subsuming the presumptions and limitations under the term 'business judgment rule' leads to confusion because the single term is then employed with reference to wholly different aspects of the rule's application, which are governed by disparate legal principles. Judicial penchant for colorful phrases such as 'gross negligence,' 'gross abuse of discretion,' and 'palpable overreaching' simply fuels the fire.

Id. (footnotes omitted) (emphasis added).

[254] Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[255] *Cf.* Johnson, *supra* note 251, at 636, 641–44 (criticizing *Aronson* for miscapturing the relationship between the duty of care and the business judgment rule by arguing that, while there is a limited relationship with the business judgment rule and the duty of care, the duty of care is an independent concept and not a component of the business judgment rule).

[256] *Aronson,* 473 A.2d at 812.

directors must exercise an informed judgment to be afforded the protection of the business judgment rule.

In *Aronson,* the Delaware Supreme Court also undertook the difficult task to define the standard of care of corporate directors in the decision-making context. The court provided an articulate standard of care expected from directors under the business judgment rule.[257] Before *Aronson*, the standard of care was built upon a reasonably prudent person standard. The reasonably prudent person standard, however, was originally designed for personal injury litigation, and it did not easily fit into the corporate director context. The abstract and strict nature of a reasonableness standard was not very helpful to determine the expected conduct from directors in dealing with complex corporate matters. In *Aronson*, the Delaware Supreme Court specified the standard of care in the corporate director context by stating that directors are required to "inform themselves … of all material information reasonably available to them."[258] Also, the court wisely placed this articulation under the business judgment rule because the justifications of the rule explain why the reasonableness standard is not compatible with corporate director context. The court avoided the reasonableness standard and related doctrinal problems simply by attaching the duty of care to the business judgment rule. In so doing, the *Aronson* court removed the directors' standard of care from the realm of tort law jurisprudence and created its own jurisprudence in the law of directors' duty of care.[259] Thus, *Aronson* formulation of the business judgment rule was clearly a step forward in the evolution of Delaware's duty of care law.

Indeed, the *Aronson* court's articulation of the standard of care in the decision-making context caused a doctrinal confusion. Commentators interpreted the *Aronson* standard of care to

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[257] Horsey, *supra* note 230, at 996 (stating that "the Delaware Supreme Court in Aronson v. Lewis had placed a concept of the standard of care expected of directors into Delaware's business judgment rule").
[258] *Aronson*, 473 A.2d at 812.
[259] Beginning with *Aronson*, Delaware courts built their own jurisprudence in the duty of care law. *See e.g.,* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 351 (Del. 1993) The *Cede* court reversed the trial court's tort law-based analysis that required the plaintiff to prove resulting injury from a duty of care breach. The *Cede* court also stated that "[t]he reasonable person standard lacks precision. Although it may appear to protect only director actions that do not constitute simple negligence, in practice it protects all director action not constituting gross negligence." *Id.* at 364 n.31; Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000) (correcting the trial court's "reasonably informed" formulation of the informational element of the business judgment rule); *see also*1 RADIN, *supra* note 161, at 438 (observing that Delaware case law rejects the reasonably prudent person standard).

include two distinct elements; procedural and substantive.[260] The procedural element required directors to "inform themselves, prior to making a business decision, of all material information reasonably available to them."[261] A substantive element followed this threshold requirement: "Having become so informed, they must then act with requisite care in the discharge of their duties."[262] An implicit two-pronged care analysis was found in a later decision of the court as well.[263]

What is not found in the commentary or court decisions is an articulate definition of the substantive element of the duty of care.[264] What exactly does substantive care mean, and how exactly does it differ from procedural care? If substantive care is independent from, and not related to, the decision-making process, then it necessarily refers to the reasonableness of a decision. In other words, substantive care necessarily relates to the substantive quality of a decision. In that case, courts should review the substantive merits of a decision to determine the availability of the business judgment rule protection. However, if the substantive quality of a

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[260] *See, e.g.,* Quillen**,** *supra* note 198, at 497 ("The duty of care subdivides into two elements as well, highlighted, fortunately, by the Supreme Court's language in *Aronson* and also by the *Trans Union* opinion."); Johnson, *supra* note 251, at 641 (stating that *Aronson* rightly distinguishes informedness and care).
[261] *Aronson*, 473 A.2d at 812.
[262] *Id.*
[263] *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). After reiterating *Aronson* formulation, the court stated that the standard of review (gross negligence) articulated in *Aronson* is "also the proper standard for determining whether a business judgment reached by a board of directors was an informed one." *Id.* In so holding, the court implicitly held that the duty of care includes two separate elements; substantive and procedural.
[264] A two-pronged duty of care formulation is not found in pre-*Aronson* decisional law as well. Before *Aronson*, Delaware courts reviewed alleged due care breaches for determining whether directors acted "without information that they can be said to have passed an unintelligent and unadvised judgment." *Mitchell*, 167 A. at 833. Accordingly, Delaware courts only examined the directors' decision making process in reviewing due care claims, and they did not require a substantive care apart from an adequate decision-making process. The substantive quality of a decision was also subject to judicial review in Delaware cases. However, the substantive quality of a decision was not reviewed to determine the substantive care. Rather, Delaware courts reviewed the substantive quality of a decision in a very limited context (waste or irrationality) and only to determine whether the decision could be attributed to any rational business purpose. *See Gimbel*, 316 A.2d at 615. It appears that the waste (irrationality) standard is the outer limit of the managerial authority bestowed upon directors by corporate statutes. Even though directors exercise due care (whether it be process or substantive care), they are responsible for a decision that is so out of pale that constitutes waste or that cannot be attributable any rational business purpose. Furthermore, most of the cases cited in the *Aronson* decision used verbal formulae—such as "fraud," "gross overreaching," "bad faith," "misconduct,"—sounding in lack of good faith rather than lack of (substantive) due care. *See Aronson*, 473 A.2d 805, 812 n.6. Therefore, *Aronson* was the first Delaware decision that made a two-pronged duty of care analysis. *See* Johnson, *supra* note 251, at 641 (noting that the *Aronson* formulation raised the question whether "the 'informed' element [is] simply one aspect of, or is it the same as, the concept of due care"). It should be also noted that after the enactment section 102(b)(7) of the Delaware General Corporation Law, Delaware courts conceptualized the waste (irrationality) standard under good faith. *See infra* Part C.1.b. (examining the waste/irrationality standard). *See also infra* notes 270–75 (examining the court decisions with respect to the informational element of the business judgment rule). Thus, after the enactment of section 102(b)(7), Delaware courts basically turned back to the pre-*Aronson* business judgment rule and waste (irrationality) analysis.

decision is reviewed for its reasonableness, the business judgment rule would have no utility in fiduciary analysis at all.[265] One may disagree with that conclusion by arguing that courts do not review the reasonableness of a decision; they apply a lenient standard in reviewing substantive care. However, that is exactly what the business judgment rule does. Where the business judgment rule is not rebutted, the substantive quality of a decision is reviewed under the lenient standard of waste (irrationality).[266] Substantive care with a lax standard of review (e.g., gross negligence) merely presents a different formulation of the traditional business judgment rule. Therefore, if *Aronson* and *Van Gorkom* included a substantive requirement under the business judgment rule, it probably referred to the outer limit of the business judgment rule (waste or rational business purpose test), not to substantive due care.[267]

One may further argue that substantive care is not related to the substantive quality of a decision, and it rather refers to mental care when making a decision. However, such care concept is implicit in the procedural element of the duty of care. Procedural care requires that directors to

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[265] *See, e.g., In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996). The *Caremark* court observed as follows:

> [C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. … To employ a different rule—one that permitted an 'objective' evaluation of the [substance of a] decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests.

Id. at 967–68 (footnotes omitted) (emphasis in original).

[266] In Delaware, the standard of care is nominally reviewed under a gross negligence standard. However, Delaware courts defined gross negligence as '"reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason."' *Disney*, 907 A.2d at 750. *See also* Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986) (citing Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) and *Gimbel* 316 A.2d at 615) (providing the same definition for a gross negligence standard). However, the Delaware Supreme Court provided the same definition as an example of bad faith in *In re* Walt Disney Co. Derivative Litig. 906 A.2d 27, 67 n.111 (2006). Logically then, the gross negligence standard in reviewing the substance of a decision is same as waste (rational business purpose test) which implies bad faith conduct. *See infra* Part C.1.b. (examining waste standard). It should be also noted that the gross negligence standard with respect to the decision-making process is not as lax as *Disney* and *Rabkin* defined. Therefore, the nature of gross negligence standard in *process* and *substance* review is different. *See infra* Part C.1.a (examining the standard of gross negligence in process review).

[267] It should be noted that neither *Aronson* nor *Van Gorkom* referred to the "rational business purpose test" (waste) of the business judgment rule in their analysis. However, before *Aronson* and *Van Gorkom*, Delaware courts made a clear distinction between the duty of care and the rational business purpose test. In *Gimbel*, which was cited in *Van Gorkom*, the court first found that the directors' decision was an informed one, and then reviewed the decision under the rational business purpose test to address the claim concerning "gross inadequacy" of the sale price of the company. *See Gimbel*, 316 A.2d at 615. Therefore, if *Aronson* and *Van Gorkom* required a substantive element under the business judgment rule, that probably referred to the "rational business purpose" (waste) requirement, not to substantive care.

employ an adequate decision-making process. An adequate process requires directors not only inform themselves of material information but also consider the material information before making a decision. An adequate decision-making process is not limited to gathering material information. Directors should review and discuss the information they gathered. In reviewing the decision-making process of directors, courts examine board meetings to determine whether directors deliberated on the available material information as well.[268] Indeed, a decision-making process solely limited to being informed of all material information, with no requirement to consider that information, would serve no purpose at all. Therefore, there is no need for a distinct substantive care other than what is implicit in the decision-making process. A slight modification of the *Aronson* standard of care would be sufficient to clarify this point. The Delaware Supreme Court's decision in a later ruling may be helpful. In *Brehm v. Eisner*, the court provided: "[I]n making business decisions, directors must *consider* all material information reasonably available."[269]

The Delaware Supreme Court may have meant something more than strict procedural care in *Aronson*. It is questionable, however, if the court's formulation required a distinct substantive care apart from an adequate decision-making process. This point shows that, although it was a big step forward in the evolution of the duty of care law, the *Aronson* analysis was not crystal clear. The court's subsequent analysis in *Van Gorkom* muddied the waters even more. Nevertheless, interpreting *Aronson* to require a distinct substantive care, at the minimum, would taint the clarity of *Aronson*'s standard of care in the decision-making context.

Regardless of what the court really meant in *Aronson* and the related doctrinal confusion, the court in its later rulings clarified that the duty of care is process due care only. In *Cede v. Technicolor*, the Delaware Supreme Court first reiterated the *Aronson* formulation by stating that the business judgment rule presumption may be invoked by directors "who have both adequately informed themselves before voting on the business transaction at hand *and* acted with requisite care."[270] The court then stated: "The duty of the directors of a company to act on an informed

[268] *See, e.g.*, *Van Gorkom*, 488 A.2d at 874 (examining the board meeting for determining whether the directors reviewed and discussed the proposed merger agreement).
[269] 746 A.2d at 259 (emphasis added).
[270] 634 A.2d at 367 (emphasis in original). *See also* Hecker, *supra* note 26, at 936 (stating that the *Cede* court intentionally truncated substantive care and arguing that there is no need for substantive care if a decision is reviewed under the entire fairness standard where the business judgment rule is rebutted because after the enactment

basis … forms the duty of care element of the business judgment rule."[271] The court also stated various times that reaching an uninformed decision constitutes a breach of the directors' duty of care.[272] Accordingly, the court equated the standard of care in the decision-making context with the informational element of the business judgment rule. In *Brehm*, the court explicitly stated that there is no substantive due care requirement under the business judgment rule, and courts do not measure, weigh, or quantify directors' judgment to determine its reasonableness.[273] The court then stated: "Due care in the decisionmaking context is *process* due care only."[274] Therefore, directors' standard of care in the decision-making context requires directors to employ an adequate decision-making process.[275]

Generally, in order to exercise an informed business judgment, directors should pay attention and devote sufficient time to corporate matters, prepare and inform themselves on proposed corporate actions, and review all material information and ask questions prior to making a decision. These activities include reading materials and engaging in other preparation before meetings, asking questions to management or advisors, requesting legal or other expert advice if required, ensuring that all information significant to a decision is available to the board and has been considered, and when relevant, bringing the director's own knowledge and experience to bear.[276] In order to comply with the duty of care, the meeting of a board should be

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of section 102(b)(7) director liability for nonpecuniary misconduct is predicated on lack of good faith and the entire fairness standard requires directors to demonstrate good faith in approving a decision or transaction).

[271] *Cede*, 634 A.2d at 367.

[272] *Id*. at 361, 366, 367.

[273] *Brehm*, 746 A.2d at 264. The court also elaborated on the Delaware Chancery Court's statement that: "A board is not required to be informed of every fact, but rather is required to be reasonably informed." The Delaware Supreme Court agreed on the part of "a board is not required to be informed of every fact." For the part of "reasonably informed" the court stated as follows:

> The 'reasonably informed' language used by the Court of Chancery here may have been a short-hand attempt to paraphrase the Delaware jurisprudence that, in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent.

Id. at 259.

[274] *Id.* at 264 (emphasis in original).

[275] It should be also noted that Delaware courts apply an objective test to determine whether directors adequately informed themselves. *See, Brehm,* A.2d 746 at 259; *cf.* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c)(2) (1994) (requires directors to be "informed with respect to the subject of the business judgment to the extent the director or officer *reasonably believes* to be appropriate under the circumstances) (emphasis added).

[276] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 19.

informative and should encourage free exchange of ideas and active and meaningful participation of directors.[277]

Nevertheless, the standard of care does not compel directors to exercise the best practices of corporate governance. In *Disney,* the Chancery Court emphasized that the best practices of corporate governance include compliance with fiduciary duties, but compliance with fiduciary duties may not be enough to satisfy the best practices of corporate governance.[278] The fiduciary duty of care encourages directors to aspire to ideal corporate governance practices, but directors do not need to achieve perfection to comply with fiduciary requirements.[279] As one commentator put it, "the duty of care is more aspirational than consequential."[280]

Also, the duty to be informed in a particular situation depends on a variety of factors such as the scale of the decision, the cost involved, and the time available to make it.[281] What constitutes an informed decision can only be determined by the context of a situation.[282] Every business decision is unique and there are no exact rules that must be followed in every decision-making process. Thus, whether directors exercised a proper attention before making a corporate decision depends on the circumstances and facts of a particular case.[283]

b. Oversight

In the oversight context, the standard of care requires directors to monitor corporate business and affairs adequately and take actions if necessary. Corporations are large and complex entities, and the boards of directors are practically not able to deal with daily operation of businesses. While they retain the ultimate responsibility, the boards delegate many of their managerial functions, formally or informally, to board committees and to the officers.[284] To the extent that they delegate the authority, the responsibility of the boards becomes to exercise a proper oversight over the delegates in managing business and affairs of the corporation.[285] To

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[277] Fogel v. U.S. Energy Sys., 2007 Del. Ch. LEXIS 178, at *7–9 (Del. Ch. Dec. 13, 2007) ("The mere fact that directors are gathered together does not a meeting make.").
[278] *Disney*, 907 A.2d at 745.
[279] 1 RADIN, *supra* note 161, at 422 (citing Cooke v. Oolie, 2000 Del. Ch. LEXIS 89, at *58–59 (Del. Ch. May 24, 2000)).
[280] P. Michael Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 521 (1989).
[281] Eisenberg, *supra* note 199, at 958.
[282] *Id.* at 949.
[283] *Graham,* 188 A.2d at 130.
[284] Hecker, *supra* note 26, at 937.
[285] *Id.*

fulfill this responsibility, the board must employ appropriate information and reporting systems in the corporation.

As indicated earlier, the directors' duty to perform an adequate oversight over a corporation was addressed by the Delaware Supreme Court in *Graham v. Allis-Chalmers Manufacturing Company.*[286] In *Graham*, the plaintiffs alleged that directors were liable for failure to prevent violations of federal antitrust laws by corporate employees that resulted in the corporation's liability.[287] The plaintiffs did not claim that directors had knowledge or suspicion of illegal conduct; rather they claimed that directors should have implemented a monitoring system in the corporation that would have alarmed them in advance to prevent it.[288] Based on an old decision of the United States Supreme Court,[289] the court held that "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."[290] The court stated that if directors have no reason to suspect that a wrongdoing exists, they are not required to install and operate a corporate system of monitoring.[291] The court found that there was no ground for director suspicion and thus concluded that directors were not liable for the misconduct leading to the corporate loss.[292]

Four decades later, the Delaware Chancery Court addressed directors' responsibilities in the oversight context in *In re Caremark International Inc. Derivative Litigation*.[293] Although *Caremark* articulates a standard sounding in lack of good faith,[294] it provides a helpful

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[286] 188 A.2d 125 (Del. 1963); *see also* Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961) (finding the directors liable for failing to perform a general supervision).
[287] *Graham,* 188 A.2d at 127.
[288] *Id* at 129.
[289] *See* Briggs v. Spaulding 141 U.S. 132 (1891).
[290] *Graham,* 188 A.2d at 130.
[291] *Id.*
[292] The court exonerated directors from liability in notably colorful terms by stating:

> In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.

Id.
[293] 698 A.2d 959 (Del. Ch. 1996). The *Caremark* opinion represents a unique situation because it contains a dictum by the Chancery Court in the approval of a proposed settlement. *See* Stone v. Ritter, 911 A.2d 362 (Del. 2006). For a discussion of *Caremark* and *Stone see infra* Part E.2.c, Chapter IV.B.2.
[294] *See* Hecker, *supra* note 26, at 940. As Professor Hecker observes, the widespread adoption of exculpatory charter provisions freeing directors from liability for monetary damages for breach of duty of care has shifted the focus in

framework in delineating directors' responsibilities in the oversight context. In *Caremark*, even though the board had a functioning committee charged with overseeing corporate compliance,[295] the plaintiffs alleged that the directors breached their duty of care by allowing a situation to develop and continue which resulted in corporate loss.[296] According to the complaint, the directors should have known that employees of the corporation were involved in violations of the federal Anti-Referral Payments Law, and they should have acted accordingly to prevent it.[297] Reassessing the holding of the Supreme Court of Delaware in *Graham*, the Court of Chancery interpreted *Graham* to mean that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."[298]

The court first noted legal developments in corporate arena on state and federal level during decades between *Graham* and *Caremark* such as Delaware jurisprudence in take-over cases[299] and adoption of Organizational Sentencing Guidelines.[300] Accordingly, the Court of Chancery concluded that, in order to satisfy the obligation to be adequately informed concerning the corporate business and affairs, directors must assure existence of appropriate information and reporting systems. These systems should be designed to provide senior management and the board timely and accurate information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations.[301] Having implemented a reporting system, directors should follow up on the information flowing to them, and take necessary actions to prevent corporate wrongdoing. Also, if there are other alerting circumstances or unusual facts to put directors on suspicion of corporate wrongdoing, directors

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oversight cases from care to good faith. For a discussion of exculpatory provisions and good faith standard *see infra* Part E.2., Chapter IV.B.2.

[295] *Caremark*, 698 A.2d at 970.

[296] *Id* at 967.

[297] *Id* at 969.

[298] *Id.*

[299] The court stated that, in take-over cases from Smith v. Van Gorkom through Paramount Commc'ns v. QVC., the Delaware Supreme Court emphasized the seriousness of the role of the board in corporate law. The court also pointed out the importance of timely and relevant information for satisfaction of a board's monitoring role under section 141 of the Delaware General Corporation Law. *Id.* at 970.

[300] The court stated that Organizational Sentencing Guidelines, adopted by United States Sentencing Commission in 1991, "offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take voluntary remedial efforts." *Id.* at 969. The Federal Sentencing Guidelines increase the penalties for corporations guilty of criminal violations, and they provide significant fine reductions for corporations with effective programs in place to prevent and detect such violations. *See* CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 35.

[301] *Caremark*, 698 A.2d at 970.

should take appropriate action.[302] Thus, in order to satisfy the oversight function, directors are under a duty to establish information and reporting systems and to review the information flowing through them.

Directors' oversight responsibility does not require them "to possess detailed information about all aspects of the operation" of a corporation.[303] Courts recognized the fact that a reporting system employed by directors cannot totally remove the possibility of wrongdoing in the corporation.[304] Directors' responsibility is then to exercise a good faith judgment to employ a reporting system which the board concludes is adequate. Directors have authority to determine the level of details that are appropriate for information and reporting systems in a corporation.[305] It is also within the directors' authority to evaluate the cost-benefit analysis of a given information system and to decide whether to install a reporting system on a given matter. Directors' good faith, disinterested decisions concerning the specifics or suitability of a reporting system are subject to business judgment rule protection.[306]

More recently, the Delaware Chancery Court addressed directors' oversight responsibility in *In re Citigroup Inc. S'holder Derivative Litigation*[307] in the context of risk-monitoring. There, the complaint asserted that directors had breached their oversight duty under *Caremark* by failing to monitor Citigroup's excessive business risk in the subprime lending market which resulted in tremendous loss for the corporation.[308] The court observed that, while directors have a responsibility to monitor a corporation's business risk, risk-monitoring falls within the realm of the business judgment rule rather than *Caremark* standard because it is inextricably related to directors' business judgment.[309] In other words, risk-monitoring is inextricably related to corporate risk-taking, and corporate risk-taking is subject to the protection of the business judgment rule. Reviewing risk-monitoring under oversight duties would inevitably lead to a hindsight evaluation of directors' business judgment, and directors' would be held unduly responsible "for failure to predict the future and to properly evaluate business risk."[310] Therefore,

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302 *Graham,* 188 A.2d at 130.
303 *Caremark*, 698 A.2d at 971.
304 ATR-Kim Eng Fin. Corp. v. Araneta, 2006 Del. Ch. LEXIS 215, at *72 (Del. Ch. Dec. 21, 2006).
305 Eisenberg, *supra* note 199, at 954.
306 *Caremark*, 698 A.2d at 970.
307 964 A.2d 106 (Del Ch. 2009).
308 *Id*. at 114.
309 *Id.* at 131.
310 *Id.*

director conduct that allegedly constitutes failure of risk-monitoring is not subject to oversight review.[311]

When performing their functions, directors must inevitably depend on the information provided them by others. Directors themselves cannot perform a detailed inquiry on every corporate matter due to the complexity of such matters and the large-scale of corporations. The law recognizes this fact and protects directors' good faith reliance on reports made by others. In performing their duties and functions, directors are entitled to rely in good faith on the information, opinions, reports, and statements of the board committees, the corporation's officers and employees, and outside experts, who directors reasonably believe merit confidence, and who have been selected with reasonable care by or on behalf of the corporation.[312] Directors' reliance is protected as long as there are no "alerting circumstances or unusual facts" that suggest further inquiry or that should put directors on notice that such reliance is unwarranted.[313] Thus, when exercising due care in performing their functions, directors' reasonable reliance on the information that is provided them by others is protected.

In *Brehm*, the Delaware Supreme Court stated that a board's reliance on a report in performing their duty of care is not protected if:

> (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter … that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) [ ] the decision of the Board was so unconscionable as to constitute waste or fraud.[314]

This section examined the development of the standard of care in the decision-making and oversight context in Delaware. Two other prominent resources pertinent to directors' standard of care are the Model Business Corporation Act (Model Act) and Principles of Corporate Governance (PCG). These two resources provide frameworks for codification of directors' duty of care. They also provide a well-developed explication of the standard of care.

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311 *Cf.* Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 978–81 (2009) (arguing that "risk management does not differ in kind from legal compliance or accounting controls" and that the *Caremark* standard includes business risk management).
312 DEL. CODE ANN. tit. 8, § 141(e) (2011); PRINCIPLES OF CORPORATE GOVERNANCE §§ 4.01(a), (b), 4.02, 4.03; *see also Van Gorkom*, 488 A.2d at 874–75 (noting that the chairman's oral presentation to the board did not qualify as a report under § 141(e) for lacking substance because the chairman was uninformed as to the essential provisions of the transaction about which he was talking).
313 PRINCIPLES OF CORPORATE GOVERNANCE § 4.02 cmt. i.
314 *Brehm*, 746 A.2d at 262 (footnote omitted).

The next section will provide a brief overview of the standard of care under the Model Act and PCG.

2. Principles of Corporate Governance and Model Business Corporation Act

In general, articulation of the standard of care under PCG and the Model Act is similar to Delaware's early standard of care (*Graham*). PCG and the Model Act build directors' standard of care upon the reasonableness concept and then attempt to alter it to fit the corporate context through different formulations and commentary.[315]

Under PCG §4.01(a), directors have a duty to perform their functions "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[316] The Model Act §8.30(b) provides that directors, "when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[317] Thus, differences exist in the formulation of the standard of care under PCG and the Model Act.

In §8.30(b) of the Model Act, the phrase "ordinarily prudent person" is omitted while it is included in PCG.[318] The official comment to §8.30(b) of the Model Act explains why this phrase is omitted as follows:

> The phrase 'ordinarily prudent person' constitutes a basic frame of reference grounded in the field of tort law and provides a primary benchmark for determining negligence. For this reason, its use in the standard of care for directors, suggesting that negligence is the proper determinant for measuring deficient (and thus actionable) conduct, has caused confusion and misunderstanding. Accordingly, the phrase 'ordinarily prudent person' has been removed from the Model Act's standard of care and in its place 'a person in a like position' has been substituted.[319]

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[315] *See e.g.,* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01cmt. h. (1994) (noting that § 4.01 does not intend to minimize special characteristics of directorship service in corporations and states that reasonable care under PCG could be referred to as requisite care); MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2 (stating that "ordinarily prudent person" standard has been removed from the Model Act's standard of care because it primarily refers to negligence concept in tort law).

[316] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a).

[317] MODEL BUS. CORP. ACT ANN. § 8.30(b).

[318] *See* PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) cmt. c. ("The use of the words 'ordinarily prudent person' is intended to convey the image of a generalist who has the capacity to perform a given corporate assignment.").

[319] MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2. However, despite the omission of the phrase "ordinarily prudent person," § 8.30(b) articulates an objective standard:

> The standard is not what care a particular director might believe appropriate in the circumstances but what a person—in a like position and acting under similar circumstances—would reasonably believe to be appropriate. Thus, the degree of care that directors should employ, under subsection (b), involves an objective standard.

Also, the Model Act provides that, in the decision-making context, directors should exercise due care "when becoming informed in connection with their decision-making function."[320] With this formulation, the Model Act explicitly recognizes that the standard of care is applicable only to the decision-making process, and it has no application with respect to the substance of a decision.[321] In other words, the standard of care is not result oriented and it is not related to the correctness of a decision.

The Model Act and PCG require directors to exercise the amount of care that a person in a like position and under similar circumstances would exercise. "In a like position" indicates the degree of care which would be used by a person if he or she were a director of a particular corporation.[322] Responsibilities of a particular director will vary depending on the tasks that have been imposed by law and by the corporation.[323] For example, if a director is on a board committee, he or she is subject to special responsibility for the performance of that committee's functions in addition to basic director responsibilities.[324] Also, the special skills, background, or expertise of a director may be relevant in evaluating that director's compliance with the duty of care.[325] However, lacking general experience or personal incompetence does not excuse directors from exercising their responsibilities.[326] By accepting a directorship position, a director accepts the duty of care responsibility for legally mandated tasks.[327] If, for example, a prominent business man has a permanent illness which prevents him from being involved in director activities, and he still agrees to serve as a director in a corporation with the limited purpose of advising the corporation for certain business practices, he will not be excused from general director responsibilities because of his special health condition.[328] The phrase "under similar

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Id. Cf. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c)(2). In the decision-making context, PCG § 4.01(c)(2) requires directors to be "informed with respect to the subject of the business judgment to the extent the director or officer *reasonably believes* to be appropriate under the circumstances." *Id.* (emphasis added). "[T]he term 'reasonably believes' has both an *objective* and a *subjective* content." *See* PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. e. (emphasis added). Thus, while § 8.30(b) of the Model Act involves an objective standard, § 4.01(c)(2) of PCG (the standard of care in the decision-making context) involves both an objective and subjective standard.

[320] MODEL BUS. CORP. ACT ANN. § 8.30(b).

[321] MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt.

[322] MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2(5).

[323] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) cmt. (e).

[324] *Id.*

[325] *Id.*

[326] MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2(6).

[327] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) cmt. (b).

[328] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) cmt. (b) illus. 1.

circumstances" recognizes the "circumstances" surrounding the specific conduct at issue in a given case.[329]

PCG requires directors to exercise the degree of care that a person in a like position "would reasonably be expected to exercise," and the Model Act requires directors to act with the degree of care that a person in a like position "would reasonably believe appropriate." PCG's reasonable care (reasonably be expected to exercise) does not intend to minimize special characteristics associated with corporate directorship, and it should be applied "with balance, fairness, and a realistic sense of what may be reasonably expected, in given circumstances."[330] In other words, reasonable care under PCG does not refer to a tort law-based standard of care, it rather points out the requisite care in the corporate context.[331] Similarly, reasonableness (would reasonably believe appropriate) under the Model Act does not refer to a tort law-based standard of care. Rather, it indicates that a director should recognize, in terms of the appropriate degree of care, the array of possible options that a director with the basic director attributes would recognize, and make a selection from the range of options within the realm of reason.[332] "[A] decision that is so removed from the realm of reason, or is so unreasonable, that it falls outside the permissible bounds of sound discretion … will not satisfy the standard."[333]

The standard of care in the Model Act and PCG requires directors to exercise due care when performing a general oversight over the corporation as well. Directors have an affirmative obligation to assure that appropriate information and reporting systems are in place to monitor corporate activities for the purposes of legal compliance and internal control.[334] There are no set formulas for oversight procedures that can be applied in every corporation.[335] The size of the corporation, the diversity of its business operations, and other similar factors may be relevant when determining oversight systems.[336] In any case, directors especially should be concerned about appropriate and effective law compliance programs. The corporation's record of law compliance in the past, its interfaces with the law, the competence and experience of corporate

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329 MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2(6); PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) cmt. (e).
330 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01cmt. h.
331 *Id*.
332 MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2(4).
333 *Id.*
334 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a)(1), (a)(2) cmt. (c).
335 *Id.*
336 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a)(1) cmt. (c).

counsel, and the cost of procedures should be considered when establishing law compliance programs.[337]

In addition, directors should make inquiry when suspicious situations arise in the corporation.[338] However, the duty to exercise care with respect to oversight function does not require directors to make "proactive inquiries searching out system inadequacies or noncompliance."[339] While directors should be attentive to their functions and obligations, they are not expected to detect the problems in the corporation in the absence of unusual circumstances that obviously require special attention.[340] PCG §4.01(a) (1) provides that the duty of care "includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary."[341]

While directors are under a duty of care when performing decision-making and oversight functions, they almost invariably have to rely on performance, judgments, and documents made or prepared by other persons or board committees. The Model Act and PCG recognize this point and provide that directors are entitled to rely on performance of board functions by persons to whom the functions are delegated, and rely on the information, opinions, reports, statements, decisions, and judgments prepared or made by delegatees.[342] The protection of directors' reliance applies to all responsibilities of the board except to the extent that delegation is expressly prohibited by the law.[343] Moreover, directors who delegate their functions should carry out the delegation in accordance with the standard of care. "[D]irectors may not abdicate their responsibilities and avoid accountability simply by delegating authority to others."[344] Directors should use reasonable care in the delegation to and supervision of the delegatees.[345] Reasonable care includes appraisal of the capabilities and diligence of the delegatee in light of his or her expertise and the review of reports concerning delegatee's activities.[346] Directors should also

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337 *Id*.
338 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a)(1) cmt. (a).
339 MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 2 (2).
340 *Id*.
341 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a)(1).
342 PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a)(2); MODEL BUS. CORP. ACT ANN. § 8.30(d), (e).
343 MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 4.
344 *Id*.
345 *Id*.
346 *Id*.

reasonably believe that the reliance on delegatees is warranted.[347] In other words, directors should believe that officers or employees of the corporation are reliable and competent in the functions they perform and that the members of board committees merit confidence.[348] If directors have actual knowledge, or if there are circumstances that should lead reasonable directors to have knowledge, that the reliance is unwarranted, and the reliance on delegatees will not be protected.[349] Thus, a director who has responsibility for the act of others fulfills this responsibility if the standard of care is met with respect to delegation of the board's functions.[350]

C. The Standard of Review: Decision-Making; the Business Judgment Rule

1. Statement and Effect of the Business Judgment Rule

The business judgment rule is the primary standard of judicial review of director conduct in the decision-making context. The rule has been developed by judges over years, and it provides a broad and well-established case law concept in corporate law.[351] The business judgment rule standard of review includes three distinct inquiries: a review of directors' financial interest in a corporate decision, a review of directors' subjective motivation, and an objective review of the process by which directors reached their decision.[352] If the directors' decision passes muster under this form of judicial review, courts will not interfere with the business judgment of directors as long as it can be attributable to any rational business purpose.

The business judgment rule has two effects: first, it insulates business decisions made by directors from judicial intervention; and second, it immunizes directors from personal liability.[353] The rule upholds institutional authority of boards and protects directors from monetary liability

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[347] PRINCIPLES OF CORPORATE GOVERNANCE §§ 4.02, 4.03.
[348] MODEL BUS. CORP. ACT ANN. § 8.30(f).
[349] MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt.
[350] MODEL BUS. CORP. ACT ANN. § 8.30 Ofcl. cmt. 4.
[351] The concept of the rule was expressed in judicial decisions in the United States about 180 years ago. *See* Arsht, *supra* note 15, at 93 n.1 (citing early cases employing the business judgment rule); Gevurtz, *supra* note 19, at 287 n.1 (same).
[352] *See* Cinerama, Inc. v. Technicolor, Inc., No. C.A. 8358, 1991 Del. Ch. LEXIS 105, at *28 (Del. Ch. June 21, 1991).
[353] 1 RADIN, *supra* note 161, at 16. *See also* Branson, *supra* note 213, at 634 (stating that some courts and commentators wrongly present this statement as the business judgment rule whereas this statement defines the result of the business judgment rule, not the rule itself). *See also* Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality,* 52 GEO. WASH. L. REV. 609, 611–12 (1984). The author makes a distinction between two functions of the rule, and provides two different concept for two separate functions. "The business judgment *rule* shields individual directors from liability for damages stemming from decisions, whereas the business judgment *doctrine* protects the decision itself." *Id.* However, this doctrinal distinction does not imply a different application in practice as the author admits that "the essential elements of rule and doctrine are the same" *Id*.

for their actions "in all but most extreme circumstances" to encourage risk taking by directors. The rule prevents courts from examining the substantive merits of directors' decisions if they make honest, informed, and unselfish business decisions.[354] In other words, it prevents a fact finder from second-guessing decisions of directors in hindsight and holding them liable simply because their decision had unsuccessful outcomes.[355] Even though the outcome of their decision may be unfortunate, directors will not be held liable in damages for honest mistakes of judgment or for conduct that might be seen imprudent or erroneous in hindsight, as long as the decision can be attributed to any rational business purpose.[356]

When directors' fiduciary conduct is challenged in a court, the business judgment rule governs judicial review of director action. In Delaware, and in most other states,[357] the business judgment rule operates as a presumption that directors are "faithful to their fiduciary duties."[358] Delaware law presumes 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."[359] The party challenging a decision has the burden to rebut the presumption by showing the failure of directors to comply with at least one of the rule's preconditions.[360] Accordingly, under the business judgment rule, courts examine a board decision only to determine whether the plaintiff has alleged and proven facts to overcome the presumption.[361] If a plaintiff is able to rebut the business judgment rule presumption, the substantive merits of the decision are scrutinized by courts for determining directors' liability.

Concisely, the business judgment rule protects directors and their decisions from legal attack if: (1) directors made a conscious decision or judgment; (2) they were free from disabling conflicts of interest; (3) they made an informed decision; (4) and they acted in good faith.[362] If

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[354] Hecker, *supra* note 26, at 956.
[355] Brehm v. Eisner, 746 A.2d 244, 260 (Del. 2000) (quoting *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 361–62 (Del. Ch. 1998)); *see also* Allen, *supra* note 250, at 11. Allen finely explained this point by stating that "the business judgment rule is the doctrinal technique used by courts to protect directors from the risks they would face were juries permitted to answer the question: "did this director when he approved this loss making transaction act as a reasonable person in the same or similar circumstances would have acted?" *Id.*
[356] 1 RADIN, *supra* note 161, at 18.
[357] *Id*. at 45.
[358] Beam v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); John J. Lynch, *The Business Judgment Rule Reconsidered,* 17 FORUM 452, 454 (1982) (stating that the rule is "a presumption of sound business judgment").
[359] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[360] Hecker, *supra* note 26, at 935.
[361] 1 RADIN, *supra* note 161, at 13.
[362] Branson, *supra* note 213, at 635.

directors' conduct satisfies these conditions, courts examine the decision made by directors only to determine whether it has a rational basis.[363] Accordingly, the business judgment rule is a standard which entails only slight judicial review of the substantive quality of business decisions.[364] Alternatively it could be called a standard of non-review because it precludes courts from reviewing the merits of a business decision that directors made.[365]

The place of the business judgment rule in the literature of corporate law is considerable. The concept of the rule has been invoked in countless legal decisions, and courts' interpretations of the rule in these decisions have been somewhat different.[366] Nevertheless, courts apply the business judgment rule generally to refrain from reviewing substantive merits of business decisions except in extreme circumstances. Under the business judgment rule, courts recognize directors' statutory authority to manage a corporation.[367] Judges recognize that corporate statutes provide directors broad discretion in making decisions; therefore, they are generally reluctant to substitute their own judgment or shareholders' judgment for that of the board. Business decisions are best determined by the good faith judgments of disinterested directors, men and women with business acumen elected by shareholders for their skill at making such decisions.[368] Hence, the business judgment rule aims to "protect and promote the full and free exercise of the managerial power granted" to corporate directors.[369]

Accordingly, courts do not evaluate the substantive merits of a decision unless directors make an uninformed decision, have personal interest in the subject matter of the decision, do not act in good faith, or act in a manner that cannot be attributed to any rational business purpose.[370] The fact that a decision is protected under the business judgment rule does not indicate that the decision was correct or was the best decision for the corporation; rather, by preventing judicial examination of the substance of the decision, the business judgment rule reinforces the

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[363] *Brehm*, 746 A.2d 264.
[364] Branson, *supra* note 213, at 631.
[365] *Id*. *See also* Johnson, *supra* note 251, at 625 (defining the business judgment rule as "a narrow-gauged policy of *non-review*") (emphasis in original).
[366] *See* Bainbridge, *supra* note 13, at 90–100 (comparing Cede & Co. v. Technicolor 634 A.2d 345 (Del. 1993) and Shlensky v. Wrigley 237 N.E.2d 776 (Ill. App. Ct. 1968) and concludes that the articulation of the business judgment rule in these two opinions substantially differ); *See also* GEVURTZ, *supra* note 90, at 286–88 (stating that when courts attempt to explain specific content of the business judgment rule a lack of consensus emerges as to what it is).
[367] *See e.g., Aronson,* 473 A.2d at 812; *Van Gorkom,* 488 A.2d at 871.
[368] *In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 984 (Del. Ch. 2007).
[369] *Disney,* 907 A.2d at 746 (citing Zapata Corp. v. Maldonado*,* 430 A.2d 779, 782 (Del. 1981)).
[370] *Brehm*, 746 A.2d at 264 n.66.

institutional authority of the board of directors in corporate structure. As the court observed in *Shlensky* v. *Wrigley*, judges will not "control the policy or business methods of a corporation although it may be seen that a wiser policy might be adopted and the business more successful if other methods were pursued."[371] Thus, where the business judgment rule is applicable, the courts will uphold the decision of the board as long as it is within the limits of rationality.[372]

The business judgment rule directs judicial inquiry where directors' fiduciary conduct is challenged. The rule is not an abstract concept to recognize directorial authority; rather, it includes certain principles and procedures to assure that directors' fiduciary liability does not intrude on boards' statutory authority. The rule "operates as both a procedural guide for litigants and a substantive rule of law."[373] Thus, the business judgment rule pervades every aspect of director fiduciary law.

Not surprisingly, the relationship between the business judgment rule and fiduciary duties of directors has been the subject of tremendous scholarly commentary. Some scholars criticized courts for not providing sufficient protection under the business judgment rule, while others criticized them for providing excessive protection. Some other scholars pointed out deficiencies in the formulation of the business judgment rule. For example, it has been argued that the presumption formulation of the rule is problematic.

The business judgment rule concept has been in use in Delaware for about a century.[374] Delaware courts formulated the concept of the rule as "presumption" long before they named it "the business judgment rule,"[375] and today the presumption formulation of the rule dominates corporate law. As a rule of evidence, it creates a presumption that directors act on informed basis, in good faith, and in the honest belief that their action is in the best interests of the corporation.[376] Accordingly, the burden is on the plaintiff challenging the action "to establish

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[371] 237 N.E.2d 776 (Ill. App. Ct. 1968).

[372] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

[373] Emerald Partners v. Berlin, 787 A.2d 85, 90–91 (Del. 2001); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (quoting Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); *cf. In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746–47 (Del. Ch. 2005) (stating "[t]he business judgment rule is not actually a substantive rule of law, but instead it is a presumption") (footnote omitted).

[374] *See* Johnson, *supra* note 251, at 639 (citing early Delaware cases that employ the business judgment rule concept).

[375] *Id.* at 640 (examining the use of the business judgment rule concept in early Delaware cases).

[376] *Cede,* 634 A.2d at 360; *Aronson*, 473 A.2d at 812; *See also Disney,* 907 A.2d 693 at 747. The court articulated the rule slightly differently in *Disney*. The court stated the rule as a presumption that directors acted on an informed basis and in the honest belief that the action taken was in the best interest of the company. The court stated that the

facts rebutting the presumption."[377] Commentators contest the presumption aspect of the rule,[378] arguing that, under traditional rules of pleading, in any case that the business judgment rule would apply the party challenging director action would already bear the initial burden of proof to show the faulty performance of directors.[379] Therefore, the business judgment rule "assigns plaintiff a burden it already had."[380] With or without the business judgment rule, a plaintiff alleging a fiduciary violation must carry the burden of showing the facts that result in violation.[381] Some commentators concluded that the procedural aspect of the rule adds nothing to the burden of a plaintiff to prove a violation of a fiduciary duty.[382] As one commentator put it, although the "presumption" formulation in fiduciary analysis is "a sound statement of legal principle," it is debatable if this statement of principle should be regarded as the business judgment rule.[383]

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presumption applies "when there is no evidence of 'fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment' on the part of the directors." *Id.* (footnote omitted). Under this formulation, good faith, fraud and self-dealing is not a part of presumption, rather they are prerequisites of the presumption.

[377] *Aronson*, 473 A.2d at 812.

[378] *See* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1345 (1993); Melvin Aron Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1271, 1283 (1993); Gevurtz, *supra* note 19, at 292; Johnson, *supra* note 251, at 627.

[379] Johnson, *supra* note 251, at 627; *See also* Branson, *supra* note 213, at 646. Branson states that the most frequent understanding of presumption in American law is the Thayerian, or bursting bubble, theory. According to the theory "a party's proof of circumstances A, B, and C (here, a judgment or decision, by duly elected directors, who exercised some care) leads to a presumption of the ultimate fact, D (here, that reasonable care was in fact exercised). If the opposing party can poke a hole in the foundational facts (conflict of interest, were woefully under-informed, and so on), then the bubble bursts and the presumption of the ultimate fact dissipates or, indeed, evaporates altogether." *Id*. Branson claims that Delaware courts "seem blissfully unaware of what the law of evidence teaches us about presumptions." *Id*. According to Branson, this may be problematic for the courts that follow Delaware if they blend "the Delaware business judgment rule with the accepted wisdom about presumptions." *Id.* Also, the author points out that the "Delaware courts require more than a pin prick—indeed, much, much more—" to rebut the due care element of the business judgment rule. *Id.* Delaware courts' traditional formulation of the rule does not fit Thayerian theory. However, Chancery Court's formulation of the rule in *Disney* is quite similar to this theory. Under this formulation, when there is no evidence of fraud, bad faith, or self-dealing, it is presumed that directors acted on an informed basis and in the honest belief that the action taken was in the best interest of the company. *Disney,* 907 A.2d at 747.

[380] Johnson, *supra* note 251, at 627; *see also* Bainbridge, *supra* note 13, at 101. The author criticizes Delaware courts—e.g., *Cede*, 634 A.2d at 345—for limiting the business judgment rule's primary function to the procedural task of assigning the burden of proof. In that limited role, "the rule merely assigns to the plaintiff the burden of establishing a prima facie case—the same burden the plaintiff bears in all civil litigation… Under this conception, the business judgment rule is nothing more than a restatement of the basic principle that the defendant is entitled to summary judgment whenever the plaintiff fails to state a prima facie case." *Id*.

[381] Balotti & Hanks, *supra* note 378, at 1346.

[382] *Id.* at 1347; Arsht, *supra* note 15, at 130.

[383] Johnson, *supra* note 251, at 627–28.

While some commentators completely reject the presumption formulation of the rule and call it trivial,[384] other commentators state that Delaware courts use the word "presumption" to mean something more than the allocation of the burden of proof.[385] According to Balotti and Hanks, Delaware courts use the presumption formulation to indicate that an increased amount of evidence is required to show directors' failure in complying with the business judgment rule's elements.[386] A more modest explanation found in PCG commentary provides that the presumption formulation of the rule "correctly signifies that no inference of dereliction of duty can or should be drawn, for example, from the fact that a corporation has suffered a business reversal."[387] In other words, a showing of corporate loss is not sufficient for a plaintiff to satisfy his or her burden to prove a fiduciary violation. The presumption formulation also indicates that the business judgment rule is not a defense that directors should invoke to protect themselves in case of faulty performance; rather it is a presumption to protect them at the outset.[388] Also, laying out the business judgment rule as a presumption introduces what a plaintiff must prove to overcome the rule's protection.[389]

Indeed, much of the discussions concerning the business judgment rule focus on the substantive aspect of the rule. The commentary on the rule's substantive aspect has followed a parallel line with the historical progress of the business judgment rule. The business judgment rule initially developed to protect institutional authority of directors to manage a corporation. However, courts' heavy emphasis on the protection afforded directors under the business judgment rule and the lack of consideration of the relationship between the business judgment

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[384] Gevurtz, *supra* note 19, at 292; Balotti & Hanks, *supra* note 378, at 1345; Eisenberg , *supra* note 378, at 1283; D. A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 835 (2007).

[385] *See* Balotti & Hanks, *supra* note 378, at 1347–53.

[386] According to the authors, the statement of the rule as a presumption shows that "larger amount of proof [is required] to satisfy the preponderance-of-the-evidence standard." *Id*. at 1348. However, as they admit as well, Delaware courts have never stated that a special evidentiary standard is required under the rule. *Cf.* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. g. (1994) (stating that the word "presumption" is imprecise and subject to misinterpretation, for example, it might be misinterpreted so that it is thought to establish a special evidentiary standard); Arsht, *supra* note 15, at 131–33 (discussing "the relative strength of the presumption" and concluding that courts require general standard of "preponderance of the evidence" under the business judgment rule, not the greater standard of "clear and convincing evidence").

[387] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 cmt. g.

[388] *See* Arsht, *supra* note 15, at 114 (formulating the business judgment rule as "a defense to liability for honest mistakes of judgment").

[389] *See id.* at 131 ("Generally, the existence of the presumed fact continues until evidence has been introduced that would justify a finding of nonexistence of the presumed fact, at which point the presumption disappears.") (quoting J. WIGMORE, EVIDENCE § 2490 (3rd ed. 1940)).

rule and the duty of care caused a misunderstanding that the rule precluded duty of care claims in corporate litigation.[390] Therefore, early commentary aimed to fix the misunderstanding by arguing that the application of the rule did not preclude due care claims. For example, Samuel Arsht, a prominent member of Delaware bar, observed that directors were required to act with reasonable diligence and care to qualify for the business judgment rule protection.[391] Arsht further observed that, the purpose of the judicial review of a decision under the business judgment rule is not to determine whether the decision was correct or one which courts would have made, but to determine whether directors exercised due care and believed, on a reasonable basis, that the challenged transaction was in the corporation's best interest.[392] Accordingly, the business judgment rule provided a defense to liability for honest mistakes of judgment, but it did not preclude a judicial inquiry in due care claims.[393] Rather, the business judgment rule served as "an outline for the relevant inquiries in determining whether directors have conducted themselves in such manner as to be entitled to the defense."[394]

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[390] *See id.* at 93 (observing that "the business judgment rule is today misunderstood, at least if one is to judge from the comments of its critics, who are, in the main, distrustful of state corporate laws and are led to suggest that the business judgment rule promises more in the way of immunity from liability than in reality it does").

[391] Arsht, *supra* note 15, at 100. Arsht examines early historical progress of the business judgment rule in Delaware decisions and concludes as follows:

> [T]he term 'business judgment rule' and the presumption that often identifies it mean simply that a stockholder who challenges a nonself-dealing transaction must persuade the court that the corporation's directors, officers, or controlling stockholders in authorizing the transaction did not act in good faith, did not act in a manner they reasonably believed to be in the corporation's best interest, or did not exercise *the care an ordinarily prudent person in a like position would use under similar circumstances*.

*Id.*at 134 (emphasis added); *cf. Aronson*, 473 A.2d at 812 n.6. The *Aronson* court, citing the cases that Arsht examined in his article, provided that directors are required inform themselves of all material information reasonably available to them and stated that the applicable standard to review the informational element of the business judgment rule is gross negligence. There is a significant divergence between the *Aronson* formulation and Arsht' approach. It should be noted, however, although Arsht requires ordinary care under the business judgment rule, he acknowledges that a lenient treatment is required when reviewing directors' duty of care under the business judgment rule. Arsht states that, under the business judgment rule, courts should refrain from reviewing the quality of a decision. Rather, courts should only examine "the evidence concerning the circumstances in which and the information on which the directors made their decision" to determine whether directors' exercised due care and had a rational basis for their decision. Arsht, *supra* note 15, at 114. Therefore, both Arsht and *Aronson* focus on the decisional process. The difference is how good that process has to be. Arsht argues that the decisional process should be reviewed under ordinary negligence. In contrast, under *Aronson*, the applicable standard to review the decisional process is lenient gross negligence.

[392] Arsht, *supra* note 15, at 114.

[393] *Id.*

[394] *Id. See also* Balotti & Hanks, *supra* note 378, at 1339 (stating that the rule "can be thought of as a statement of the circumstances" for judicial deference to director judgment); Johnson, *supra* note 251, at 626 (stating that the rule functions as a "streamlined judicial framework" to review fiduciary performance of directors).

The Delaware Supreme Court, however, followed a different path in articulating the relationship between the duty of care and the business judgment rule. In 1984, the court provided now often-stated formulation of the business judgment rule in *Aronson v. Lewis*.[395] In *Aronson*, the directors' standard of care was not predicated upon a tort law-based ordinary care or reasonableness standard. Rather, the court provided a new articulation of the standard of care under the business judgment rule by stating that directors should "inform themselves of all material information reasonably available to them" to invoke the business judgment rule.[396] The court also stated that applicable standard of review to determine if directors were informed was gross negligence.[397] Accordingly, instead of referring to an ordinary care standard and then injecting some flexibility into it, the court articulated a new standard of care in the decision-making context that was suitable in the corporate director context. In so doing, the court avoided doctrinal problems arising out of the incompatibility of ordinary care in the director decision-making context. Thus, the *Aronson* decision was a turning point in Delaware law in terms of defining the relationship between the duty of care and the business judgment rule.[398]

Although the *Aronson* formulation of the business judgment rule has dominated corporate law for last several decades, it did not end doctrinal controversy concerning the duty of care and its relationship to the rule. One commentator rejected the court's formulation by arguing that there is no need for special protection for corporate directors.[399] Another criticized *Aronson* for subsuming the duty of care under the business judgment rule and argued that the duty of care should be treated as an independent concept rather than as an element of the business judgment rule.[400] Others criticized Delaware courts for disregarding the public policy underlying the business judgment rule.[401]

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[395] 473 A.2d 805 (Del. 1984).
[396] *Id.* at 812.
[397] *Id*.
[398] *See* Horsey, *supra* note 230, 996–97 (praising *Aronson* for clarifying the relationship between the business judgment rule and the duty of care by providing and articulate standard of care expected of directors in the decision-making context); Quillen, *supra* note 198, at 497 (praising *Aronson* for embracing a single descriptive label as a standard of review (gross negligence) under the business judgment rule).
[399] *See* Gevurtz, *supra* note 19, at 287–89.
[400] *See* Johnson, *supra* note 251, at 648–54.
[401] *See* Bainbridge, *supra* note 13, at 129–30.

Professor Gevurtz, for example, argues that the business judgment rule is meaningless or misguided and it should be abolished.[402] According to Gevurtz, the statement that courts will not interfere with decisions of disinterested and informed directors who are in good faith does not mean anything different than the statement that "directors are not be liable for their decisions unless there is a reason to hold the directors liable-such as when the directors have breached their duty of care."[403] In another words, it simply means directors will only be liable if they breach their fiduciary duties.[404] Although Gevurtz acknowledges that the business judgment rule evokes less judicial scrutiny for the substance of directors' decision,[405] and that courts interpret the rule to employ a lax standard of culpability for the duty of care,[406] he rejects justifications for a special standard for corporate directors under the duty of care,[407] and argues that the rule should be completely abolished.[408]

Lyman Johnson criticizes Delaware courts for assigning an overarching role to the business judgment rule to shape judicial review of fiduciary conduct.[409] Johnson states that the rule should not be seen as "a generalized liability shield" or "a presumption that directors did not breach their duty of care."[410] Rather, the business judgment rule is a "narrow-gauged policy of *non-review,*" and it precludes courts from reviewing the substantive merits of directors' decisions in the duty of care context.[411] Johnson states that, in Delaware, the business judgment precludes a substantive review of a decision only if directors make an informed decision.[412] He

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[402] Gevurtz, *supra* note 19, at 289, 293 (stating that the only thing the business judgment rule adds to the existing fiduciary law is "a cautionary note that an error in judgment or a mistake—in the sense of a decision that does not turn out as one hoped—does not automatically equal negligence").
[403] *Id*. at 288; *see also* Balotti & Hanks, *supra* note 378, at 1347 (stating that the protection of the business judgment rule "cannot be anything other than a recognition that if the plaintiff proves any of certain elements—lack of due care (measured by a gross negligence standard applied to the decision-making process), lack of honest belief of action in the corporation's best interests, abuse of discretion or (maybe) lack of good faith—plus causation and damages, the director will be liable for a business decision").
[404] Gevurtz, *supra* note 19, at 291.
[405] *Id*. at 302.
[406] *Id*. at 295.
[407] For a discussion of policy reasons underlying the business judgment rule *see infra* Part C.3.
[408] Gevurtz, *supra* note 19, at 289.
[409] Johnson, *supra* note 251, at 625 (stating that Delaware courts wrongly formulate the business judgment rule, and that the wrong formulation stems from the *Aronson* decision).
[410] *Id*. at 628.
[411] *Id.* at 625.
[412] *Id.* at 646 (stating that Delaware courts rightly apply half of the business judgment rule when directors fulfill the duty of care, and they should apply the other half of the business judgment rule when directors breach their duty of care because courts "should (and need) not review the substantive merits of the business decision as a separate basis for upholding the decision or absolving directors of liability for a 'good' (or 'fair') decision").

argues that the business judgment rule should preclude a substantive review of a decision *even though* directors fail to inform themselves before making a decision. As an alternative to Delaware version, Johnson proposes the "modest" business judgment rule under which "the 'substantive' force of the business judgment rule *always* applies in a duty of care case, immunizing the *quality* of the business decision from judicial review whether or not care was exercised."[413] Under the modest business judgment rule, the substantive "rationality" or "reasonableness" or "fairness" of a decision is excluded from judicial review in the duty of care context.[414] Therefore, the modest business judgment rule always applies in the duty of care cases, and precludes courts from reviewing the quality of directors' decision even in the absence of a proper decision-making process. If directors fail to perform an informed decision-making process, they should be liable for damages proximately caused by their faulty action.[415] Thus, Johnson argues that "failures of informedness" should be treated as independent wrong causing liability, and it should not be a reason for "judicial incursion" into directors' business judgment.[416]

William Allen, a former Chancellor in Delaware, on the other hand, supports a strong business judgment rule which eliminates due care liability of directors.[417] According to Allen, the business judgment rule precludes judicial review of the duty of care claims if directors acted in good faith. Allen criticizes Delaware courts[418] for attempting to erase the strong protection of the business judgment rule and asserts that such erosion would be to the detriment of shareholders.[419] Allen justifies the strong business judgment rule with the existence of extralegal forces shaping director conduct such as reputation concern, economic incentives, and

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[413] *Id*. at 632 (emphasis in original).
[414] *Id.* Thus, Johnson rejects Delaware's approach that a failure to exercise proper due care leads to the application of an entire fairness standard (or any other standard). For a discussion of the entire fairness standard *see infra* Part C.4.b.
[415] *Id.* at 650.
[416] *Id.* at 644. A complete analysis of Johnson's modest business judgment rule proposal requires a discussion of the entire fairness standard under the business judgment rule. For a discussion of the entire fairness standard and for a subsequent discussion of the modest business judgment rule *see infra* Part C.4.b.
[417] Allen, *supra* note 250, at 12; *see also* Bainbridge, *supra* note 13, at 87 (stating that "the rule creates a strong presumption against judicial review of duty of care claims").
[418] Allen, *supra* note 250, at 13 (stating that Delaware courts' "willingness to closely review the reasonableness of board processes and decisions" was first seen in mid 1980s and then in the *Disney* case).
[419] *Id.*

shareholder pressure.[420] In addition, shareholders' ability to cheaply diversify their risks of loss in stock market provides an adequate protection for bad director judgments.[421]

Likewise, Stephen Bainbridge's conceptualization of the business judgment rule as a doctrine of abstention excludes judicial review of director conduct in due care setting. Bainbridge proposes the abstention doctrine as an alternative to Delaware's standard of review formulation of the business judgment rule.[422] According to Bainbridge, Delaware's treatment of the business judgment rule as a standard of review implies that judicial review of director conduct is the norm rather than the exception.[423] Under the abstention doctrine, however, the principle is that directors' decisions will not be subject to any kind of review in the absence of exacting conditions.

To illustrate abstention doctrine, Bainbridge compares the holdings of *Shlensky v. Wrigley*[424] and *Cede & Co. v. Technicolor, Inc.*[425] In *Shlensky*, the court stated that "courts will not interfere with honest business judgment of the directors unless there is a showing of fraud, illegality or conflict of interest."[426] The Delaware Supreme Court, on the other hand, defined the business judgment rule in *Technicolor* as being intended "to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."[427] Bainbridge argues that the *Technicolor's* formulation wrongly suggests far less judicial deference to a board decision than *Shlensky.*[428] Accordingly, the Delaware approach facilitates judicial review of directors' decisions whereas it should principally preclude such a review.[429]

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[420] *Id.*
[421] *Id.* at 12.
[422] Bainbridge, *supra* note 13, at 95.
[423] *Id*. at127.
[424] 237 N.E.2d 776 (Ill. App. Ct. 1968).
[425] 634 A.2d 345 (Del. 1993).
[426] *Shlensky,* 237 N.E.2d at 778.
[427] *Technicolor,* 634 A.2d at 360.
[428] Bainbridge, *supra* note 13, at 90–100. It should be noted that the issues in these two cases were quite different. In *Shlensky*, the plaintiff contested the business policy of the board and asked the court to interfere with the board's discretion claiming that the decision did not serve the interests of the corporation and its shareholders. This issue typically falls under the board's authority to manage a corporation assigned by statutes, and courts are likely to refuse to honor such demands. In *Technicolor*, however, the plaintiff contested a specific wrongdoing by directors, not the decision itself. The plaintiff alleged that directors violated their duty of care by reaching their decision in a faulty process and therefore they should be liable for damages. The issue in *Technicolor* was not to determine whether board's judgment serve the interests of shareholder, rather it was to determine whether directors sufficiently informed themselves prior to decision-making. Consequently, the *Technicolor* court applied a different analysis than the court did in *Shlensky*. It is a well-established principle in Delaware law that the authority to manage corporations belongs to the board of directors and courts will not interfere with it as long as the board exercise its authority within the limits of the law. For example, in Zapata Corp. v. Maldonado, the Delaware Supreme Court stated that "the

The abstention doctrine reflects the doctrinal approach that directors should not be liable for their actions if they act in good faith. The theoretical background of the doctrine stems from the "director primacy" model developed by Bainbridge.[430] Under this model, between two competing values of authority and accountability, deference should be given to director authority to facilitate central decision-making in corporations.[431] Therefore, the main purpose that shapes the operation of the business judgment rule under the abstention doctrine is preservation of board authority rather than reduction of the personal liability risk of directors. Because "the power to hold to account is ultimately the power to decide,"[432] emphasis on director accountability rather than authority shifts part of the board's decision-making authority to shareholders or judges.

Accordingly, under the abstention doctrine, courts should refrain from reviewing directors' decisions unless they are tainted by illegality, fraud, or self-interest.[433] The abstention doctrine presumes that directors acted in good faith, and the good faith presumption of the business judgment rule protects directors from judicial review of duty of care claims.[434] In this conception, "good faith does not state a standard of liability but rather establishes" the business judgment rule presumption.[435] If a plaintiff cannot rebut the good faith presumption of the business judgment rule, courts should dismiss due care claims without further inquiry.[436] Consequently, in the absence of fraud, self-interest, illegality, and bad faith, there is no review of director conduct whatsoever, not even for rationality.[437]

Accordingly, the business judgment rule's main function under the abstention doctrine is "to preclude courts from deciding whether the directors violated their duty of care."[438] To uphold the board's authority, the abstention doctrine rejects the informational element of Delaware's business judgment rule, and prevents courts from even asking the question: did the board

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business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors." 430 A.2d 779, 782 (Del. 1981).

429 Bainbridge, *supra* note 13, at 93. *Cf.* Arsht, *supra* note 15, at 114 (stating that the business judgment rule "functions not to preclude [due care] inquiry, but to guide it").

430 *See generally,* BAINBRIDGE, *supra* note 128.

431 *Id.* at 114, 130.

432 Bainbridge, *supra* note 13, at 103 (footnote omitted).

433 *Id*. at 96–97.

434 Bainbridge, *supra* note 13, at 90.

435 *Id* at 90.

436 *Id.*

437 *Id*. at 99 n.101.

438 *Id.* at 101.

exercise some care prior to decision-making?[439] Under the abstention doctrine, "the requisite questions to be asked are more objective and straightforward: Did the board commit fraud? Did the board commit an illegal act? Did the board self-deal?"[440] Thus, the abstention doctrine puts a prophylactic barrier preventing judicial review of director conduct for a duty of care claim.[441]

The abstention doctrine addresses practical and legal concerns associated with directors' duty of care. It is questionable, however, if these concerns should amount to create an absolute barrier to duty of care claims. Courts developed the business judgment rule to address very same concerns. The rule was initially developed to recognize directors' statutory authority to manage a corporation. Under the business judgment rule, courts do not honor a shareholder demand to interfere with the business policy of a corporation. If the business judgment rule is applicable, judicial review of a decision is limited to determine if the decision is attributable to any rational business purpose. To invoke the business judgment rule, directors are not required to exercise a reasonable care; rather, they are only required to make an informed decision. Furthermore, courts review the informational element of the business judgment rule under lenient gross negligence standard. Although gross negligence is not a precise standard, it is incontestable that it requires worse dereliction than ordinary negligence. Therefore, unlike the abstention doctrine, Delaware's business judgment rule attempts to set a fair balance between directors' statutory authority and accountability under the common law duty of care.

The abstention doctrine ignores that authority and accountability "form a two-way street."[442] Just as the authority rationale serves to justify the need for the business judgment rule's protection, the business judgment rule "serves to establish the practical limits" on the board's authority "because [the rule] defines the zone in which courts and shareholders cannot interfere."[443] Samuel Arsht, who significantly contributed to Delaware corporate law,[444] provided a well-considered explanation as to how the business judgment rule should function to align competing values in corporate law. Arsht observed as follows:

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[439] *Id*. at 95. "Put another way, the whole point of the business judgment rule is to prevent courts from even asking the question: did the board breach its duty of care?" *Id*. "Whether or not the board exercised reasonable care is irrelevant, as well it should be." *Id*. at 128.
[440] *Id*. at 128.
[441] *Id.*
[442] Davis, *supra* note 17, at 589.
[443] *Id.*
[444] Arsht served as Chairman of the drafting committee of the Delaware Corporation Law Revision Commission, which drafted the Delaware General Corporation Law, enacted in 1967.

> The importance of the business judgment rule for the current deliberations over corporate governance does not lie only in the rule's simple recognition that directors ought not be liable for honest mistakes of judgment or unpopular business decisions. Its significance lies also in the limitations to its availability as a defense to liability and the standard of directorial conduct those limitations establish.
>
> Far from constituting a shield from liability for fraud, mismanagement, or reckless decisions, the limitations on the business judgment rule's application impose significant duties on a director in the performance of his or her office.
>
> …
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> Because of the limitations placed on the directors' discretion if they are to have the benefit of the business judgment rule, the rule does not preclude inquiry, but instead mandates inquiry into the facts and circumstances of a challenged transaction to such extent as may be necessary to enable the court to ascertain whether the director's decision was an exercise of informed, reasoned judgment or an arbitrary or reckless decision. As the Third Circuit recently observed: '[w]e do not think that the business judgment of the directors should be totally insulated from judicial review. In order for the directors' judgment to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment.'[445]

Properly understood, the business judgment rule does not preclude judicial inquiry into directors' decisions; rather it strikes a compromise between directors' authority and fiduciary duties. The business judgment rule recognizes the authority of directors but also prescribes boundaries to that authority to assure that it is exercised within the limits of law. Samuel Arsht further observed:

> [T]he rule functions not to preclude inquiry but to guide it, for where a business decision of directors is challenged, the court must examine the evidence concerning the circumstances in which and the information on which the directors made their decision. This inquiry is made, not for the purpose of ascertaining whether the decision made was correct or one which the court would have made, but to ascertain whether the evidence does or does not establish that the directors exercised due care and believed, on a reasonable basis, that the challenged transaction was in the corporation's best interest.[446]

Thus, the business judgment rule imposes meaningful limitations before providing a strong protection in favor of directors. Courts developed the business judgment rule concept over the years by considering different factors in the corporate mechanism. The rule, as formulated in Delaware, ensures that courts do not interfere with directors' judgment in the duty of care context as long as they comply with the minimal due care standards when exercising their statutory authority. Delaware courts apply lenient standards of review under the business judgment rule to determine due care compliance of directors. Under the business judgment rule,

[445] Arsht, *supra* note 15, at 96, 125–26 (citation omitted).
[446] *Id.* at 114.

directors' decision-making process is reviewed under the gross negligence standard, and the substance of the decision is reviewed under the waste standard. Following sections examine the standards of gross negligence and waste.

a. Gross Negligence

As a normative matter, the duty of care requires directors to act with "the ordinary care expected of a reasonably prudent fiduciary."[447] Notwithstanding, courts purposely apply the lenient standard of gross negligence under the business judgment rule for determining whether directors employed an informative and deliberative process before making a decision. By setting the standard of review at the more lenient level of gross negligence, courts intend to provide directors a greater freedom arena to encourage them to act without undue inhibition.[448] As former Chancellor Allen observed:

> Because business corporations are risk-taking institutions and because the intelligent assumption of risk can be impeded were courts free to second-guess questions of whether a board had enough information to act prudently, the legal test of whether directors are adequately informed is rather high: gross negligence.[449]

Therefore, although directors are expected to act with ordinary care, courts will find a breach of the duty of care only if directors fail to reach an informed decision in a grossly negligent manner. Examining the relevant court decisions, one commentator nicely summarized judicial inquiry into the directors' decisional processes under gross negligence as follows:

> Proof of a breach of the duty of care rests on objective facts. The court will look at the amount of time available to directors to prepare for the meeting, the extent of the directors' preparation for the meeting, time spent by the directors at the meeting, the type and quality of the advice available to the directors, the directors' participation in the meeting, and the documents the directors reviewed. Such proof, standing alone, is sufficient to establish a breach of the duty of care.[450]

In Delaware, a clear expression of gross negligence as the applicable standard to review the directors' decisional processes is found in *Aronson v. Lewis*.[451] There, the Delaware Supreme Court held that "under the business judgment rule director liability is predicated upon concepts of gross negligence."[452] The court later reaffirmed the gross negligence standard in its famous

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447 Allen, Jacobs & Strine, *supra* note 208, at 449.
448 *Id.*
449 Cinerama, Inc. v. Technicolor, Inc., No. C.A. 8358, 1991 Del. Ch. LEXIS 105, at *52 (Del. Ch. June 21, 1991).
450 Clark W. Furlow, *Good Faith*, *Fiduciary Duties, and the Business Judgment Rule in Delaware*, 2009 UTAH L. REV. 1061, 1084–85 (2009) (footnotes omitted).
451 473 A.2d 805 (Del. 1984).
452 *Id*. at 812.

ruling of *Smith v. Van Gorkom*.[453] The court provided a further elaboration in *Van Gorkom* by stating that gross negligence is "the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[454] Accordingly, in order to pierce the business judgment shield on the ground of the informational element in Delaware, a plaintiff must show that directors reached their decision by a grossly negligent process that includes a failure of considering all material information reasonably available.[455]

Defining the gross negligence standard, however, proves a more difficult job than determining it as the applicable standard of review. What precisely does a gross negligence standard mean and how exactly is this standard different from ordinary negligence? There is no articulate definition of gross negligence found in court decisions to supply a clear answer to these questions.[456] It is incontestable that gross negligence suggests a worse dereliction than ordinary negligence, and courts intend to employ a lenient treatment under the gross negligence standard.[457] Despite that, the concept of gross negligence is a "notoriously ambiguous" standard,[458] and the ambiguous nature of gross negligence creates skepticism whether that standard serves the purpose for which it was designed. For example, one commentator observed that "it is common to find that courts that purport to apply that standard actually apply a standard that is either more or less demanding."[459] Other commentators noted that it is questionable whether the application of the gross negligence standard, rather than an ordinary negligence

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[453] 488 A.2d 858 (Del. 1985).
[454] *Id*. at 873.
[455] Brehm v. Eisner, 746 A.2d 244, 259, 264 n.66 (Del. 2000) (confirming *Aronson* by stating that "directors must *consider* all material information reasonably available, and that the directors' process is actionable only if grossly negligent") (emphasis added).
[456] In Rabkin v. Philip A. Hunt Chem. Corp., the court stated "gross negligence would appear to mean, 'reckless indifference to or a deliberate disregard of the stockholders,' or actions which are 'without the bounds of reason.'" 547 A.2d 963, 970 (Del. Ch. 1986) (citing Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) and Gimbel v. Signal Companies, Inc., 316 A.2d 599, 615 (Del. Ch. 1974) *aff'd,* 316 A.2d 619 (Del.1974)). *See also In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 750 (Del. Ch. 2005) (providing the same definition for the gross negligence standard). This definition, however, not very helpful because it suggests a far more lax standard than the standard Delaware courts actually apply under gross negligence. For example, the Delaware Supreme Court provided the same definition as an example of bad faith in *Disney*. 906 A.2d at 67 n.111.
[457] *Cf*. Quillen, *supra* note 198, at 496 ("Courts do not have much trouble with excessively protective labels and, if they are offended by what the director did, it is not difficult to label the action 'reckless,' 'grossly negligent,' or a 'gross abuse of discretion.'").
[458] Eisenberg, *supra* note 168, at 448; *see also* Gevurtz, *supra* note 19, at 299 (stating that "it is difficult to pin a precise meaning upon the term gross negligence").
[459] Eisenberg, *supra* note 168, at 448.

standard, would make a critical difference to the outcome.[460] In other words, if one is under a duty to fulfill certain requirements, applying gross negligence or ordinary negligence may have little impact on the outcome when determining the fulfillment of these requirements.[461]

The Delaware Supreme Court's ruling in *Van Gorkom* presents a perfect example to discuss the uncertain nature of a gross negligence standard. In *Van Gorkom*, the court found defendant directors to have breached their duty of care in a grossly negligent manner for approving the sale of the corporation in a two-hour meeting relying upon the chairman's twenty-minute oral presentation.[462] The directors' grossly negligent conduct included a failure to make an inquiry into the intrinsic value of the corporation, to perform an adequate market test, and to read and discuss the material terms of the merger agreement.[463] However, commentators argued whether directors really needed to go through this process because they were high caliber businessmen with impeccable credentials, they were thoroughly familiar with the corporation and its financial status, and the agreed sale price represented a fifty percent premium over the stock market value of the corporation.[464] While the majority of the court found the directors'

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[460] *See* E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 928 (1980); Gevurtz, *supra* note 19, at 299 (noting that "it is not easy to find cases applying the gross negligence standard to directors' actions in which use of this standard, rather than an ordinary negligence test, unquestionably made a critical difference to the outcome").

[461] *See also* Quillen, *supra* note 198, at 497–98. Former Justice Quillen observed as follows:

> Even if one assumes that negligence law is the proper pigeonhole for director liability—a most questionable assumption at least at the decisional level—the concept of 'gross negligence' has been expressly rejected by the better tort scholarship as practically meaningless. Therefore its recent adoption in corporate law would appear, in some respects, to be an analytical step backwards.

Id. (footnote omitted).

[462] *Van Gorkom*, 488 A.2d at 874, 880.

[463] *Id.*

[464] *Id.* at 894–99 (dissenting opinion). For rejecting that "the boards' collective experience and sophistication" was sufficient to make an informed decision concerning the sale of the company, the *Van Gorkom* court relied on *Gimbel v. Signal Companies, Inc.,* 316 A.2d 599 (Del. Ch. 1974), *aff'd per curiam,* 316 A.2d 619 (Del. 1974). However, in *Gimbel*, the primary issue was gross inadequacy of the sale price, not informational element of the business judgment rule. The *Gimbel* court first found that the directors' decision was an informed one and then reviewed the decision under rationality standard due to alleged gross inadequacy of sale price. The court provided:

> The factors, which suggest imprudence and perhaps some others such as the differences that Signal Oil personnel had with the De Goyler and MacNaughton report and certain potential liabilities of Signal which survive the sale, do not in my judgment raise at this stage a reasonable probability that *the plaintiff will be able to pierce the 'business judgment' standard*. When considered in light of the whole case*, they do not in themselves justify the conclusion that the 'directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment.'* But, and perhaps particularly on this preliminary application, the full circumstances surrounding the approval do relate to the overriding factual issue in the case. What

conduct grossly negligent, many commentators concluded that the directors' conduct did not constitute even ordinary negligence.[465] Regardless who is right or wrong as to the result of the case, the extensive doctrinal controversy triggered by *Van Gorkom* proves that a gross negligence standard is troublesome.[466]

If *Van Gorkom* did not, the Delaware Supreme Court's later ruling in *Cede v. Technicolor*[467] proved the unprincipled nature of the gross negligence standard. In *Van Gorkom*, the court found directors' conduct grossly negligent mainly because they had failed (1) to have an independent valuation of the corporation or, *alternatively*, to perform an adequate post-agreement market test, and (2) to receive and review the material terms of the proposed merger agreement. The *Van Gorkom* court required directors to perform a market test because they initially failed to obtain an independent fairness opinion concerning the agreed sale price, and an adequate market test would cure that initial failure.[468] Therefore, a market test was an alternative requirement, not an independent one. As opposed to *Van Gorkom*, the defendant directors in *Cede* received an independent fairness opinion concerning the proposed sale price, they reviewed the material terms of the proposed merger agreement, they discussed the feasibility of other potential bids, and they made a conscious judgment to proceed with the proposed merger

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> was Signal Oil worth on December 21, 1973? Or to put the question in its legal context, did the Signal directors act *without the bounds of reason* and *recklessly* in approving the price offer of Burmah?

Id. at 615 (citation omitted) (emphasis added).

[465] *See* Eisenberg, *supra* note 168, at 448; Gevurtz, *supra* note 19, at 299; Quillen, *supra* note 198, at 498; Allen, Jacobs & Strine, *supra* note 208, at 458–59 (criticizing *Van Gorkom* for disregarding "Delaware's long-standing policy of deferring to business decisions made by well-motivated fiduciaries" under the gross negligence standard, and stating that, while purporting to apply the gross negligence standard of review, *Van Gorkom* court "in reality (but not explicitly) applied an ordinary negligence standard").

[466] The Delaware Supreme Court's analysis concerning the *Van Gorkom* holding in a later case shows that the *Van Gorkom* applied a more exacting standard than gross negligence. In Cinerama v. Technicolor, 663 A.2d 1156 (Del. 1995), the court observed as follows:

> [B]ecause this Court had decided the *substantive* entire fairness issue adversely to the board in *Van Gorkom,* the only issue to remand was the amount of damages the Court of Chancery should assess in accordance with *Weinberger.* Whereas in *Van Gorkom* liability was decided *before* remand, in this case, a condition precedent to a finding of liability was an adverse determination regarding entire fairness *after* remand.

Id. (emphasis in original). Logically, if the *Van Gorkom* court's analysis included a substantive fairness analysis, the standard that the court applied to review the directors' conduct should be more exacting than the gross negligence standard.

[467] 634 A.2d 345 (Del. 1993).

[468] *See Van Gorkom*, 488 A.2d at 878.

agreement.[469] Nevertheless, the court found directors' conduct grossly negligent mainly because they failed to perform a pre or post-signing market test, and they did not have reasonable basis not to do so.[470] Accordingly, the *Cede* court applied a more demanding test under the gross negligence standard than *Van Gorkom*.[471] William Allen, who rendered the trial court decision in *Cede*, observed in a later article, joined by two co-authors, as follows:

> If anything, the *Cede II* court's language is suggestive of a 'higher-than ordinary-care' standard in cases involving a sale of the company, but in all events *Cede II* does not articulate a gross negligence standard of review, which by definition is far less exacting than 'ordinary negligence.'[472]

Alternatively, the *Cede* holding can be seen as an application of the enhanced level of required care in the context of a sale of a corporation.[473] In that account, the *Cede* ruling confirms the commentators' observation that applying the gross negligence standard, instead of the ordinary negligence standard, will have little impact on the outcome because the *Cede* analysis heavily focused on the lack of market test rather than giving sufficient weight to the other factors such as the independent fairness opinion. Therefore, what really matters is not the application of a gross or ordinary negligence standard; it is rather the fulfillment of the requirements of the duty of care in the factual context of the specific transaction at issue.

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[469] *Cede*, 634 A.2d at 355.

[470] *Id.* at 369.

[471] Nevertheless, one should not blame the *Cede* court for that reason because the court's main focus was not whether or not the directors' conduct was grossly negligent, rather, the court's focus was on the trial court's erroneous holding that required the plaintiff to show a resultant injury to establish liability. The trial court did not elaborate on the gross negligence issue and instead emphasized the plaintiff's failure to show an injury, and the Supreme Court followed the same path by focusing on the trial court's erroneous holding instead of elaborating on the gross negligence issue. In other words, the trial court found a fertile ground in the case to direct Delaware fiduciary law in accordance with tort law analysis, and in return, the Supreme Court found fertile ground in reviewing the trial court's erroneous holding to direct and clarify judicial review of fiduciary conduct in accordance with the precedent and reversed the case by requiring the application of the entire fairness standard. *See infra* Part C.4.b. (examining the entire fairness standard in general and discussing *Cede's* application of the entire fairness standard).

[472] Allen, Jacobs & Strine, *supra* note 208, at 459.

[473] The *Cede* court required a market test under Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). *See* Allen, Jacobs & Strine, *supra* note 208, at 459. The authors elaborated on this point as follows:

> [T]he court stated that 'a director's duty of care requires a director to take an active and direct role in the context of the sale of a company from beginning to end,' and that 'the directors individually and the board collectively [must] inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company.' While we do not quarrel with (and indeed applaud) that standard as a description of the board's duty in the precise context of selling the company, our point is that the quoted language does not describe gross negligence.

Id. (citation omitted).

Thus, Delaware courts employ the concept of gross negligence to review directors' duty of care because that concept contains a certain level of flexibility. A flexible standard of review allows courts to consider the specific circumstances related to a particular factual setting in a duty of care context. A flexible standard of review is necessary in the duty of care context because of the fact-specific characteristic of that duty. The duty of care has no fixed content, and its requirements vary depending on the circumstances in which a decision was made. Under the gross negligence standard, courts attempt to give directors certain amount of running room when reviewing the performance of the duty of care. One noted commentator observed:

> Courts that purport to adopt a gross-negligence standard to review the duty to monitor, the duty of inquiry, or the duty to employ a reasonable decision-making process, probably do so because the performance of these duties seldom presents a cut-and-dried issue, and the gross-negligence standard of review emphasizes the importance of leaving a play in the joints in determining whether the relevant standard of conduct was satisfied in such cases.[474]

But again, the flexibility inevitably involves uncertainty, and the uncertainty precipitates undesired results related to directors' duty of care. Despite courts' tendency to employ a lenient standard, the ambiguous nature of gross negligence makes it very hard to provide sufficient assurance to corporate directors in the context of the duty of care, especially when one considers the special characteristics of board service. Directors often deal with complex business matters under unusual circumstances and uncertain conditions, business matters necessarily involve risk, and directors are entitled to exercise a discretional authority when dealing with corporate matters. Due to the special characteristics of corporate directorship service, the ambiguity involved in the gross negligence standard outweighs its advantageous features in the context of the directors' duty of care.

Furthermore, Delaware courts apply an objective test under the gross negligence standard.[475] Commentators raised concern regarding the appropriateness of a pure objective test for evaluating directors' decision-making process.[476] Commentators suggested that recognizing the special characteristic of board service may be more helpful than employing a pure objective test under the uncertain gross negligence standard.[477] One commentator noted that, "in

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[474] Eisenberg, *supra* note 168, at 448–49.
[475] *Brehm,* 746 A.2d at 259.
[476] *See e.g.,* Quillen, *supra* note 198, at 498 (stating that "the duty of inquiry should have both an objective and a subjective nexus with need or desirability" and stating that Delaware's "all material information reasonably available … test puts the emphasis on access rather than need or desirability").
[477] This approach is arguably found under PCG § 4.01(c)(2), which requires a director to be " informed with respect to the subject of the business judgment to the extent the director or officer *reasonably believes* to be appropriate

information gathering, a negligence standard without the superlatives may be appropriate so long as courts recognize that 'circumstances' vary."[478] Another observed as follows:

> The same point can be made, without using the problematic gross negligence standard, by employing the terminology of due care rather than the terminology of negligence, and by making clear that in determining whether directors or officers acted with due care, courts should consider the complexities of the corporate context and give a certain amount of running room.[479]

Alternatively, it can be argued that a more articulate definition of the standard of care may solve problems associated with the gross negligence standard. The problems associated with the gross negligence standard mainly stem from the fact-specific feature of the duty of care. Recognizing that this feature of the duty of care may be problematic in the corporate context, Kenneth Davis suggested the standardization of procedures that directors should employ when performing board service.[480] Davis acknowledges that "the directors' role presents significantly less room for standardization than the established professions."[481] He argues, however, at least two areas may be candidate for standardization:

> One area is *Smith v. Van Gorkom* and its progeny, which requires a target's directors to take reasonable efforts to inform themselves, including obtaining and reviewing fairness opinions, before deciding how to respond to an acquisition offer. The other area is the authorities indicating the board's duty to assure the existence of an information and reporting system regarding the corporation's compliance with the law.[482]

He states that, while requiring adherence to certain standard practices and procedures may be seen as an intrusion to the board's sovereignty, it would improve the overall quality of the

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under the circumstances." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c)(2) (1994) (emphasis added). In contrast to Delaware's objective gross negligence standard, § 4.01(c)(2) involves both an objective and subjective test. *See* PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. e. ("[T]he term 'reasonably believes' has both an *objective* and a *subjective* content.") (emphasis added). Thus, the PCG formulation suggests an objective evaluation of the decision-making process along with the subjective factors (e.g., the directors' expertise) and the special circumstances in which the directors made their decision.

[478] Quillen, *supra* note 198, at 500.

[479] Eisenberg, *supra* note 168, at 449.

[480] Davis, *supra* note 17, at 582–86. *See also* Quillen, *supra* note 198, at 495. Former Justice Quillen observed:

> The problem exists in part because of the nature of equity. The approach is to a case as a whole, based on all the relevant circumstances, rather than the elemental approach employed, for example, in the criminal law. … But, to speak heresy, maybe a more consistent and *codified elemental approach* is needed. In the modern business world, directors are asked to make significant business decisions swiftly. For simple self-defense, are they not entitled to *a clear legal standard* by which to measure, at the time of decision, their personal liability for the necessary business risk attached to their occupation?

Id. (emphasis added).

[481] Davis, *supra* note 17, at 582.

[482] *Id.* (footnotes omitted). He states that "the issue underlying the standard[ization] must recur with sufficient frequency—across factual settings with common elements—to give rise to a body of case law and commentary sufficient to support the emergence of a consensus." *Id.* at 585.

board's performance in the long run.[483] In his view, insistence on standardized practices and procedures would facilitate the ability of directors to play an active role in corporate decision-making and oversight, and it would make "it harder for those … directors who are unduly deferential to management to cover their tracks."[484] Accordingly, the standardization of board practices would assist directors in complying with the duty of care and thereby avoiding personal monetary liability.

b. Waste (Irrationality)

If a plaintiff is not able to rebut the business judgment rule presumption, courts will examine a decision under the exceptionally limited standard of waste.[485] Under the waste standard, a plaintiff must show that directors' decision cannot be attributed to "any rational business purpose."[486] If a decision is so egregious, irrational, or far beyond "the bounds of reason,"[487] or if "directors irrationally squander or give away corporate assets,"[488] courts will not respect the judgment of directors. A waste of corporate assets will occur if a corporate transaction is so exceptionally "one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[489] Courts will enjoin a transaction or hold directors liable where a decision fails to satisfy the onerous waste standard.

As one can tell from its definition, the waste standard is extremely deferential to directors' judgment. The waste standard puts "a nearly insurmountable barrier" in front of a

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[483] *Id.* at 595.
[484] *Id.*
[485] Judicial review under the waste standard is also referred to as "irrationality standard." *See, e.g.*, Eisenberg, *supra* note 168, at 442–43; Quillen, *supra* note 198, at 494–95.
[486] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) (stating that the waste standard is a corollary of the proposition that where the business judgment rule is applicable courts will not interfere with directors' decision if it can be attributed to any rational business purpose) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del.1971)).
[487] Gimbel v. Signal Companies, 316 A.2d 599 (Del. Ch. 1974), *aff'd,* 316 A.2d 619 (Del. 1974); Parnes v. Bally Entertainment Corp., 722 A.2d 1243, 1246 (Del. 1999) ("so far beyond the bounds of reasonable judgment"); Brehm v. Eisner, 746 A. 2d 244, 264 (Del. 2000) (stating that "irrationality is the outer limit of the business judgment rule", and it may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith"); *see also* Arsht, *supra* note 15, at 107 (stating that "rational business purpose" test is a correct articulation of one of the elements of the business judgment rule); Quillen, *supra* note 198, at 500 (stating that rational business purpose review fits corporate context because under this standard courts recognize that "there are many rational courses of business action, a wide spectrum, and [rationality is] not just a two-dimensional spectrum"); *cf.* Bainbridge, *supra* note 13, at 99 (rejecting rational business purpose review); Johnson, *supra* note 251, at 650 (stating that rational business purpose review should be limited to examine a decision only to verify a linkage between the decision-making process and outcome).
[488] *Disney*, 906 A.2d at 74.
[489] *See Brehm*, 746 A. 2d at 263.

plaintiff.[490] It is very unlikely that directors will be held liable for corporate waste because courts apply a very undemanding test under that standard. Under the waste standard, courts do not review the overall reasonableness of a decision. Whether directors exercised a poor business judgment or made an unreasonably risky decision is not related to the waste inquiry.[491] Courts will not evaluate the quality of a decision if there is any possibility that it was based on a legitimate business reason.[492] For example, if some business people agree that the transaction is as a whole conceivable or imaginable, yet differ on the sufficiency of terms, the court will respect the judgment of directors.[493] In a transactional context, a court will find waste only if the consideration for an exchange of corporate assets is "so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[494] A decision or transaction constitutes corporate waste only if it is "so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it."[495] Under the waste standard, courts provide directors the widest latitude at the decisional level.[496] The undemanding test that courts apply under the waste standard "preserves a minimum and necessary degree of director and officer accountability."[497]

There are very few cases in which the directors were found liable for corporate waste.[498] In *Selheimer v. Manganese Corp. of America,* for example, the court imposed liability on

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[490] Lisa L. Casey, *Twenty-Eight Words: Enforcing Corporate Fiduciary Duties through Criminal Prosecution of Honest Services Fraud,* 35 DEL. J. CORP. L. 1, 21 (2010).
[491] *See* Quillen, *supra* note 198, at 500. Under the rational business purpose requirement, "there are many rational courses of business action, a wide spectrum, and not just a two-dimensional spectrum. The area of director discretion is enlarged in a positive vein, not limited by negative description." *Id.*
[492] *See* Davis, *supra* note 17, at 576 ("the focus is not on what the hypothetical reasonable director *would* have done but on what some rational director *might* have done") (emphasis in original).
[493] Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 478 (1992).
[494] White v. Panic, 783 A.2d 543, 554 (Del. 2001).
[495] Allen, Jacobs & Strine, *supra* note 208, at 452.
[496] Quillen, *supra* note 198, at 500.
[497] Eisenberg, *supra* note 168, at 443.
[498] Those cases were decided in jurisdictions other than Delaware. *See, e.g.,* Selheimer v. Manganese Corp. of America, 224 A.2d 634, 423 Pa. 563 (Pa. 1966); Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940); Hun v. Cary, 82 N.Y. 65 (1880). *See also* Dooley, *supra* note 493, at 480 n.59 (examining *Litwin* and *Hun*); *cf.* Kamin v. American Express Co., 86 Misc.2d 809 (N.Y. Sup. Ct. 1976). In *Kamin*, American Express acquired common stock of another company for investment at a cost of $29,900,000. *Id.* at 811. After the value of the stock significantly decreased, the board of American Express declared a special dividend to the company's shareholders to distribute depreciated shares in kind. *Id*. The plaintiff claimed that the board's action constituted waste because if those depreciated shares were sold in the market, the company would sustain capital loss of $25,000,000 and this loss would result in $8,000,000 tax savings to the company. *Id.* at 810–11. The record before the court showed that directors were fully aware that the company would realize tax savings if the shares were sold in the market, but they avoided this option because such a sale would require the company to show a loss of $25,000,000 in the company's

directors because they wasted corporate funds to utilize a plant that they knew it was very unsuitable for profitable production.[499] The plant "lacked a railroad siding, a proper storage area, and its equipment was 'out of phase'" for profitable commercial operation.[500] Furthermore, before pouring corporate money to the unprofitable plant, the company had initiated the purchase of another plant that was far better suited and superior than old plant for commercial operation.[501] Nevertheless, directors ignored the plans on the second plant and proceeded to blindly stack corporate money on the first one. In addition, the directors failed to provide any "satisfactory explanation" or "advance any justification" for their actions.[502] The court concluded that the directors' actions constituted waste of the corporation's assets and held them liable for the consequences of their actions.[503]

A number of Delaware cases conceptualized the waste standard in the context of good faith. The waste standard involves a very limited review of the substantive merits of a business decision.[504] Under this substantive review, the directors' judgment will not be respected by courts "in those rare cases where the decision under attack is 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'"[505] In *Lewis v. Vogelstein*, former Chancellor Allen implied that the substantive review of a decision under the waste standard is a way of inferring bad faith.[506] Allen observed as follows:

> The judicial standard for determination of corporate waste is well developed. Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any*

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financial statement and that might have a negative effect on the market value of the company's publicly traded stock. *Id.* at 813–14. The court held that it is within the board's authority to make such a decision and dismissed the complaint stating that a claim "which alleges merely that some course of action other than that pursued by the board of directors would have been more advantageous gives rise to no cognizable cause of action." *Id.* at 812. In other words, the directors' decision was not inexplicable.

499 224 A.2d 634 (Pa. 1966).

500 *Id*. at 639.

501 *Id.*

502 The court stated: "It is beyond explanation, why, in the face of such knowledge of the unsuitability of the Paterson plant for profitable production, the defendants continued to pour corporate money into and to utilize the Paterson plant." *Id.*

503 *Id*. at 646.

504 Indeed, the exceptionally limited scope of judicial inquiry under a waste (irrationality) standard resonates the obligation of good faith rather than the duty of care. *See* Quillen, *supra* note 198, at 492 ("'[A] rational business purpose' [ ] seem to relate, giving normal meaning to the English language, more to a good heart rather than a sound mind. The phrases all emphasize a duty of loyalty rather than a quality of judgment.").

505 *Parnes*, 722 A.2d at 1246 (quoting *In re* J.P. Stevens & Co., Inc.*,* 542 A.2d 770, 780–81 (Del. Ch. 1988)).

506 699 A.2d 327, 336 (Del. Ch. 1997).

> *substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky. Any other rule would deter corporate boards from the optimal rational acceptance of risk, for reasons explained elsewhere. Courts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, *ex post,* to judge appropriate degrees of business risk.[507]

The Delaware Supreme Court implicitly confirmed that waste implies bad faith conduct. In *White v. Panic*, the court stated that a claim must fail under the waste standard if "there is *any substantial* consideration received by the corporation, and ... there is a *good faith judgment* that in the circumstances the transaction is worthwhile."[508] Indeed, if directors of a corporation are exculpated from personal monetary liability by a charter provision pursuant to section 102(b)(7), a finding of director liability for corporate waste should be logically predicated upon bad faith. The Delaware Supreme Court's review of a corporate waste claim in *Disney*, where directors were exculpated under section 102(b)(7), demonstrates that a waste of corporate assets constitutes bad faith.[509] Professor Hecker, analyzing the *Disney* Court's waste review, observed as follows:

> Although the court did not make the point explicitly, it is clear that waste is bad faith conduct. Logically, if this were not so, waste would be exculpable and there would have been no need to decide the merits of whether the severance package amounted to waste. In addition, waste, as defined by the court, is certainly qualitatively more culpable than gross negligence and yet does not involve disloyalty as classically defined. As such, it falls into that middle ground that the court identified as requiring proscription by means of the duty of good faith….The necessary conclusion is that waste constitutes bad faith conduct and thus falls outside the protection of both the business judgment rule and section 102(b)(7) exculpatory provisions.[510]

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[507] *Id.* (emphasis in original) (citations omitted); *see also In re* RJR Nabisco, Inc. S'holders Litig., 14 DEL. J. CORP. L. 1132 (Del. Ch. 1989). There, Allen explained the relation between waste and bad faith as follows:

> As I conceptualize the matter, such limited substantive review as the rule contemplates *(i.e.,* is the judgment under review 'egregious' or 'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith. I am driven to this view because I can understand no legitimate basis whatsoever to impose damages (or enter an injunction) if truly disinterested directors have in fact acted in good faith and with due care on a question that falls within the directors' power to manage the business and affairs of the corporation. To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors. It might be correctly said that whether one infers bad faith from an 'egregious' or 'irrational' decision (thus depriving it of business judgment rule protection) or directly strips the decision of that protection upon such a finding, is of little practical importance.

Id. at 1156 n.13 (footnotes omitted).

[508] *White,* 783 A.2d at 554 (quoting Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (quoting *Vogelstein*, 699 A.2d at 336)).

[509] *Disney*, 906 A.2d at 73–75.

[510] Hecker, *supra* note 26, at 952.

However, it should be noted that, under the waste standard, courts do not make an initial inquiry into the subjective good faith of directors. When reviewing a claim of corporate waste, instead of inquiring into the directors' subjective motivation or intention, the court looks at the outcome of a decision. If a decision is so unconscionably irrational as to constitute waste, the court automatically equates directors' wasteful decision with bad faith. In other words, a decision does not constitute waste because it was made in bad faith; rather, a corporate waste constitutes bad faith. If a decision is exceptionally one sided or irrational, a court concludes that the decision is inexplicable on any ground other than bad faith, without making an inquiry into the directors' subjective good or bad faith. Thus, as one commentator observed, the waste standard "serves as an objective confirmation of the critical, but entirely subjective, requirement that the directors have a good faith belief that their decision is in the corporation's best interest."[511]

2. Preconditions for Application of the Business Judgment Rule

The business judgment rule applies if directors: (1) make a judgment or decision; (2) inform themselves of all material information reasonably available relevant to a decision; (3) are free from conflict of interest regarding the subject matter of a decision; (4) and act in good faith. Indeed, the business judgment rule operates as a presumption that directors fulfilled its preconditions. Accordingly, a plaintiff has the burden to rebut the presumption by showing that directors have failed to comply with at least one of the preconditions. If the plaintiff cannot meet this requirement, directors' decision is protected by the business judgment rule so long as it can be attributed to any rational business purpose.

There is a threshold requirement of director judgment or decision for application of the business judgment rule.[512] The rule "operates only in the context of director action."[513] If directors "have either abdicated their functions, or absent a conscious decision, failed to act," the business judgment rule presumption is not available.[514] For example, directors' failure to make

[511] Davis, *supra* note 17, at 576.
[512] *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del Ch. 1971) (stating that application of the rule's presumption depends upon a showing that "directors did, in fact, make a business judgment authorizing the transaction under review" and "that director judgment was brought to bear with specificity on the transactions"); *see also* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. to § 4.01(c) (1994) (stating that for application of the rule's presumption "a decision must have been consciously made and judgment must in fact have been exercised").
[513] *Aronson,* 473 A.2d at 813.
[514] *Id.*

due inquiry in the oversight context does not qualify for the rule's presumption.[515] If, however, directors made a conscious judgment or decision to refrain from acting, the business judgment rule presumes that the decision was disinterested, informed, and in good faith.[516] Thus, the rule's presumption applies only if there is a decision to act or not to act, but it has no application where "directors' inaction was the result of ignorance."[517]

An "unintelligent or unadvised" decision is not protected under the business judgment rule.[518] To afford the rule's protection, directors should "inform themselves, prior to making a business decision, of all material information reasonably available to them."[519] This element requires directors to inquire into information that is "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking."[520] Directors should make their judgment or decision upon considering the information they gathered. In other words, the informational element requires directors not only to gather material information but also to digest such information before making a decision. Accordingly, directors should exercise an informed attention on corporate matters by devoting sufficient time to gather, review, and discuss material information. Directors' responsibility is not to review every fact concerning a corporate action; it is rather to review "material facts that are reasonably available."[521] There is "no pre-set formula that corporate boards must follow" to make an informed corporate decision.[522] Therefore, the adequacy of directors' decision-making process depends on the special circumstances of a particular factual setting.

To invoke the protection of the business judgment rule, directors should also be free of conflict of interest in a corporate decision or transaction. Directors are considered to be interested if they appear on both sides of a transaction, or if they expect to derive any personal financial benefit from a transaction that is adverse to that of the corporation or its stockholders.[523] "A director is interested if he will be materially affected, either to his benefit or

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[515] Eisenberg, *supra* note 168, at 441.
[516] *See e.g. Aronson,* 473 A.2d at 813; Nixon v. Blackwell, 26 A.2d 1366 (Del. 1993); Rales v. Blasband, 634 A.2d 927 (Del. 1993).
[517] Rabkin v. Philip A. Hunt Chemical Corp 57 A.2d 963 (Del. Ch. 1986), *reargument denied,* 1987 Del. Ch. LEXIS 522, 1987 WL 28434 (Del. Ch. Dec. 17, 1987).
[518] *Disney*, 907 A.2d at 748 (quoting Mitchell v. Highland-Western Glass*,* 167 A. 831, 833 (Del.Ch.1933)).
[519] *Aronson,* A.2d at 812.
[520] Brehm v. Eisner, 746 A.2d 244, 259 n.49 (Del. 2000).
[521] 1 RADIN, *supra* note 161, at 309.
[522] *Id.* at 816 (quoting Stepak v. Addison*,* 20 F.3d 398, 410 (11th Cir. 1994)).
[523] *Aronson*, 473 A.2d at 812; *Rales,* 634 A.2d at 936.

detriment, by a decision of the board, in a manner not shared by the corporation and the shareholders."[524] For example, a director who buys property from the corporation is interested in that transaction. In addition to being free of conflict of interest in a corporate transaction, directors should be independent of anyone having such benefit.[525] In other words, directors should not be dominated or controlled by a person or entity that has material interest in the transaction. In those cases where directors self-deal to advance their "personal profit or betterment"[526] or act under extraneous considerations or influence, the business judgment rule protection is unavailable.[527]

Finally, directors must act in good faith to be afforded the protection of the business judgment rule.[528] Good faith requires "a true faithfulness and devotion to the interests of the corporation and its shareholders."[529] The rule does not protect director actions taken in bad faith.[530] Directors are required to make their decision "in good faith and in the honest belief that the action taken was in the best interests of the company."[531] Directors should give priority to the interest of the corporation and its shareholders in their actions. Directors' actions lack good faith if they are made "with a purpose other than that of advancing the best interest of the corporation."[532] Director action with intent to harm the corporation or to violate applicable positive law also lacks good faith.[533] Thus, directors must be true to the best interest of the corporation in their actions to be afforded the protection of the business judgment rule.

3. Policy Reasons supporting the Business Judgment Rule

The principal purpose of the business judgment rule is "to protect and promote the role of the board as the ultimate manager of the corporation."[534] The rule is common law recognition of the fundamental statutory principle that the business and affairs of a corporation are managed by

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524 Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. 1995) (citation omitted).
525 *See, e.g., Aronson*, 473 A.2d at 816; *Rales*, 634 A.2d at 935.
526 *Disney*, 907 A.2d at747 (quoting Grobow v. Perot*,* 539 A.2d 180, 187 (Del. 1988)).
527 However, if an interested transaction is approved by the majority of fully-informed directors or shareholders, the applicable standard of review is the business judgment rule. *See infra* Chapter IV.A.2. (examining DEL. CODE ANN. tit. 8, § 144 and interested director transactions).
528 *See, e.g., Aronson*, 473 A.2d at 812; *Van Gorkom*, 488 A.2d 872.
529 *Disney,* 907 A.2d at 755.
530 1 RADIN, *supra* note 161, at 331(quoting *In re* Croton River Club, Inc.*,* 52 F.3d 41, 45 (2d Cir. 1995)).
531 *Aronson*, 473 A.2d at 812.
532 *Disney*, 907 A.2d at 755.
533 *Id.*
534 *Id.* at 746 (citing Zapata Corp. v. Maldonado*,* 430 A.2d 779, 782 (Del. 1981)).

or under its board of directors.[535] Under the business judgment rule, neither courts nor shareholders are entitled to interfere with the managerial authority of directors.[536] The board is elected by shareholders to manage the corporation because of their expertise in business, and courts are ill-equipped to second-guess sophisticated business decisions. Every business decision requires individual discretion and judgment, and courts should respect directors' judgment even if it turns out badly. The business judgment rule insulates directors' decision-making authority from judicial review in those cases where the directors' decision does not satisfy some shareholders or where the directors' exercise of their statutory authority results in an unfortunate outcome to the corporation. By precluding judicial inquiry into directors' authority on the basis of shareholder dissatisfaction or unfortunate outcomes, the business judgment rule ensures that the board's statutory power to manage a corporation remains intact.

There are also a number of fairness and policy reasons underlying the rule related to directors' duty of care. Although the rule was initially developed to protect directorial authority, over time it expanded to include judicial review of directors' duty of care in the decision-making context because performance and review of that duty is to some extent related to directorial authority. Therefore, courts and commentators articulated a number of fairness and policy reasons for the business judgment rule in order to protect directors from personal liability in due care claims. Fairness and policy reasons also help delineate special characteristics of corporate directorship service.

Fairness and policy reasons supporting the business judgment rule are well explicated; directors often make risky business decisions under uncertain conditions and they should not be responsible for honest mistakes in judgment; judges are ill-equipped to evaluate the substantive merits of a business decision because they lack business expertise and they review a business decision with the benefit of hindsight; the disproportion between the compensation of board service and the potential enormous liability associated with board service may disincentivize

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[535] *See* DEL. CODE. ANN. tit. 8, § 141(a). Delaware courts often attribute the business judgment rule to the statutory authority of the board of directors to manage a corporation. *See e.g. Aronson,* 473 A.2d at 812 (stating that "[t]he business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)"); *Van Gorkom*, 488 A.2d, at 872 (stating that "[u]nder Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 *Del.C.* § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors"). *See also* Davis, *supra* note 17, at 587 (stating that "within the limits implicit in the business judgment rule, it is the board's choice, not that of the judge or a disgruntled shareholder, that must prevail").

[536] Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994); *see also* Arsht, *supra* note 15, at 95 ("directors are not…able to please all of the stockholders all of the time").

qualified people from serving as directors; and the law should encourage directors to make risky decisions without fear of personal liability.[537]

Corporate directors often make complex business decisions under conditions of uncertainty.[538] Complex business decisions require highly sophisticated judgments. Directors make corporate decisions by considering a wide variety of factors and under the pressure of time

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[537] In addition, commentators justified the rule "by a desire to conserve judicial resources by not permitting every business decision to be reviewed in court." Arsht, *supra* note 15, at 99–100. *See also* Branson, *supra* note 213, at 632 (same). Others provided alternative justifications for the business judgment rule. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1439–40 (1985) (stating that standard justifications of the rule are "helpful but not entirely satisfactory.") Fischel explains the rationale supporting the business judgment rule as follows:

> My argument is that the role of liability rules is more limited in the corporate than other contexts because of several factors, including the cost of contracting which makes it extremely difficult to distinguish adequate or reasonable performance from a breach of fiduciary duty; the specialization of function in public corporations; the role of contractual and market mechanisms in rewarding good business decisions and penalizing inferior ones coupled with the absence of similar mechanisms to discipline judges' decisions; and the weak incentive of small shareholders and their attorneys to maximize the value of the firm.

Id. Others completely reject the justifications of the business judgment rule. *See, e.g.*, Gevurtz, *supra note* 19, at 304–12. By comparing board service with other professions, Gevurtz argues that the justifications of the rule are not unique to the corporate director context, and, therefore, there is no reason to limit the scope of judicial review of the directors' decisions. Gevurtz stated:

> The difficulty with [the rule's justifications] is generally not that they lack any truth. On the contrary, the primary problem is that these rationales prove too much, for they could apply with equal force to numerous other situations in which the rule of ordinary negligence commonly applies.

Id. at 304–05. *Cf.* Davis, *supra* note 17, at 575, 580–82 (distinguishing tort law and corporate fiduciary law based on risk-allocation rationale, and distinguishing board service from other professions based on non-standardization rationale). Davis explains his non-standardization rationale as follows:

> The reason that we allow judges and juries to pass judgment on the professional actions of, say, a neurosurgeon is not that we assume that they have the personal expertise to make an informed assessment or evaluation on their own. We instead rely on expert testimony. Underlying that reliance is the assumption that there exists a generally accepted body of principles and procedures dictating how a reasonable neurosurgeon should respond in a variety of situations. Consequently, we are comfortable permitting the fact finder to draw inferences about what the defendant neurosurgeon should have done from the expert's opinion on what he or she would have done if confronted with the same situation.
>
> The job of corporate director, in contrast, has never been governed by standardized procedures and protocols, for at least three reasons. First, the universe of situations facing directors is too vast and varied to permit the development of much in the way of uniform procedures, other than such basic activities as attending meetings and reviewing financial information. Similarly, the diverse backgrounds and experience of individual directors make it impossible to assume the existence of any widely shared body of training, knowledge, or professional culture. This is an inevitable byproduct of the law's choice…to frame the prerequisites for service as a director in terms of fundamental attributes such as judgment and common sense rather than some specific level of business expertise.

Id. at 581–82 (footnotes omitted).

[538] Bainbridge, *supra* note 13, at 121.

and market conditions. Business is not an exact science and it necessarily involves discretionary assessment based on unusual facts. When dealing with complex business matters, directors may make mistakes even though they act in good faith. It is not fair to hold directors responsible for honest mistakes in their judgment because this type of mistake is inextricably related to the very nature of business.[539]

Furthermore, judges are primarily trained for legal expertise, and they lack requisite expertise in business for reviewing the substantive quality of business decisions.[540] Indeed, even if judges gained expertise in the business field; it would not be desirable to permit them to second-guess substantive merits of a business decision because shareholders elect the directors, not the judges, to manage the corporation. The concern here is "the perceived institutional impropriety of public officials evaluating the substantive quality of private sector business decisions."[541] Judges review directors' decisions in a sterilized court room after the fact, and they do not face the practical difficulties related to the risky nature of a business decision. Judicial review of the quality of business decisions is also tainted by the benefit of hindsight.

When directors make their decision, there is a range of plausible alternatives to consider.[542] At the same time, each alternative possesses a risk of loss.[543] Even if directors exercise sound business judgment and make a careful choice among such alternatives, the decision might result in a loss to the corporation because the risk associated with this particular alternative may materialize.[544] In this instance, the loss is not a result of the directors' fault;

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[539] *See* Arsht, *supra* note 15, at 99–100 ("The rule is a necessary recognition of human fallibility."). As the court observed in Hodges v. New England Screw Co.,:

> [I]f the [directors'] mistake be such as with proper care might have been avoided, they ought to be liable. If, on the other hand, the mistake be such as the directors might well make, notwithstanding the exercise of proper care, and if they acted in good faith and for the benefit of the [corporation], they ought not to be liable.

1 R.I. 312, 346 (1850) (quoted from Johnson, *supra* note 251, at 637).
[540] *See* Lynch, *supra* note 358, at 454; Bainbridge, *supra* note 13, at 119 ("Judges likely have less general business expertise than directors. They also have less information about the specifics of the particular firm in question."); Branson, *supra* note 213, at 637 ("[Business] decisions often involve intangibles, intuitive insights or surmises as to business matters such as competitive outlook, cost structure, and economic and industry trends. Business decisions often come down to matters of touch and feel not susceptible to systematic analysis.").
[541] Johnson, *supra* note 251, at 648.
[542] *See* Bainbridge, *supra* note 13, at 114.
[543] *See* Eisenberg, *supra* note 168, at 444.
[544] *See* Bainbridge, *supra* note 13, at 114 ("Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly.").

rather, it is a result of the risky nature of corporate business.[545] After the loss occurred, however, shareholders and courts may tend to attribute the loss to the decision-makers.[546]

Accordingly, the concern here "is that '[i]nstead of truly judging directors' *behavior,* [judges] would take bad *results* as conclusive evidence of bad behavior.'"[547] After the fact reviewers are simply inclined, with the benefit of hindsight, to assume that the loss was foreseeable and preventable, ex ante.[548] Courts cannot perfectly evaluate a business decision ex post because "[t]he circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information."[549] Therefore, "a reasoned decision at the time made"[550] may appear "in hindsight to have been made improvidently,"[551] and, therefore, courts may erroneously impose liability on directors for decisions that resulted in a loss to the corporation.[552] The business judgment rule reduces the risk of such unfair liability by limiting judicial review of the substantive merits of corporate decisions.

The business judgment rule is also necessary to attract competent individuals to serve as outside independent directors on corporate boards without fear of personal liability.[553] Reasonable persons would not serve on boards if the law imposed liability for honest mistakes in

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[545] *See* Eisenberg, *supra* note 168, at 444 ("If the executive chooses one alternative and the associated negative risk materializes, the decision is 'wrong' in the very restricted sense that if the executive had it to do all over again he would make a different decision, but it is not a bad decision.").

[546] *See* Bainbridge, *supra* note 13, at 114 ("Decision makers tend to assign an erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring. If a jury knows that the plaintiff was injured, the jury will be biased in favor of imposing negligence liability even if, viewed ex ante, there was a very low probability that such an injury would occur and taking precautions against such an injury was not cost effective."); Davis, *supra* note 17, at 575 ("When those losses are incurred, hindsight may introduce fresh doubts into the soundness of the decision.").

[547] Johnson, *supra* note 251, at 632–33 (quoting C.A. Riley, *The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard,* 62 MODERN L. REV. 697, 710 (1999)) (emphasis in original).

[548] *See* Allen, *supra* note 250, at 12 ("The first is the obvious fact that in any subsequent shareholder attack on the attentiveness of the board, the judicial system cannot perfectly distinguish after the fact between business decisions that were negligent and those that were prudent but mistaken or unlucky.").

[549] Joy v. North*,* 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied,* 460 U.S. 1051 (1983).

[550] *Id.*

[551] 1 RADIN, *supra* note 161, at 30 (quoting Resolution Trust Corp. v. Blasdell, 930 F. Supp. 417, 423 (D. Ariz. 1994)).

[552] *See* Bainbridge, *supra* note 13, at 115 ("Hence, there is a substantial risk that suing shareholders and reviewing judges will be unable to distinguish between competent and negligent management."); Allen, *supra* note 250, at 12 ("…in any subsequent shareholder attack on the attentiveness of the board, the judicial system cannot perfectly distinguish after the fact between business decisions that were negligent and those that were prudent but mistaken or unlucky.").

[553] *See* Branson, *supra* note 213, at 637 ("The business judgment rule now more than ever is necessary to encourage truly independent persons to serve as directors."); Allen, Jacobs & Strine, *supra* note 208, at 455 ("Highly qualified directors may also avoid service if they face liability risks that are disproportionate to the benefits of service.").

judgment.[554] The liability of directors for the consequences of a failed business decision would likely be far out of proportion compared to the incentives associated with the directorship.[555] Directors of public corporations typically receive a small compensation for their board service.[556] Likewise, directors' ownership interests in their corporations are usually very small.[557] Corporations' losses from failed business decisions and resulting director liability, however, may be in excess of millions of dollars.[558] Therefore, while directors benefit very little from successful business decisions, they might face enormous liability because of failed corporate projects.[559] This disjunction between personal risk and reward could deter competent people from serving as corporate directors.[560] The business judgment rule eliminates this "disproportion between directors' upside and downside risks" by protecting them from liability for errors in judgment.[561] The rule's liability shield encourages qualified people to serve on corporate boards, which is in the interest of the corporation and its shareholders.[562]

Furthermore, the business judgment rule encourages directors to pursue risky business strategies that potentially provide greater profit for shareholders.[563] Shareholders invest in corporations with an expectation of profit, and "potential profit often corresponds to the potential

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[554] *See* Arsht, *supra* note 15, at 97 ("The business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge."); *see also* Joy, 692 F.2d at 885 ("shareholders to a very real degree voluntarily undertake the risk of bad business judgment.").
[555] Eisenberg, *supra* note 168, at 445.
[556] *See* Gagliardi v. Trifoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).
[557] *Id.* ("[T]hey enjoy (as residual owners) only a very small proportion of any 'upside' gains earned by the corporation on risky investment projects.").
[558] Eisenberg, *supra* note 168, at 445.
[559] *See* Allen, *supra* note 250, at 12 ("…given the scale of modern business corporations losses from investment decisions may be very large while directors individual proportion of gains from a wise decision will be comparatively small...").
[560] *See Gagliardi,* 683 A.2d at 1052 ("Given the scale of operation of modem public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects.").
[561] Allen, *supra* note 250, at 12.
[562] *See* Eisenberg, *supra* note 168, at 445 ("…in the absence of some brake on such liability, it might become more difficult to attract qualified candidates as non-management directors…").
[563] *See* Allen, Jacobs & Strine, *supra* note 208, at 455. The authors observed as follows:

> That deference furthers important public policy values and underscores the social utility of encouraging corporate directors to make decisions that may create corporate wealth but that are also risky. If law-trained judges are permitted to make after-the-fact judgments that businesspersons have made 'unreasonable' or 'negligent' business decisions for which they must respond in monetary damages, directors may, in the future, avoid committing their companies to potentially valuable corporate opportunities that have some risk of failure.

Id.

risk."[564] It is in the interests of shareholders that directors engage in risky business investments because, over time, riskier investments produce higher return.[565] Accordingly, rational shareholders do not want, or should not want, directors to be risk averse.[566] If directors were to be held responsible for consequences of failed business decisions, however, they would simply be disinclined to make risky business decisions.[567] Why would directors make risky decisions if they might be responsible for the losses, while the profits would flow to the shareholders if successful?[568] Absent protection from personal liability for unfortunate outcomes of risky projects, directors would be unduly risk averse and overly cautious, and that would defeat the profit-seeking purpose of shareholders.[569]

Therefore, the business judgment rule protection is necessary to promote informed risk-taking by directors, which is essential to business success.[570] Directors should minimize the risk of loss by exercising informed and good faith business judgment, but they should not be afraid to make risky business decisions.[571] Overall, corporations' losses from inactivity and hesitancy

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[564] *Joy*, 692 F.2d at 885.
[565] *See* Hecker, *supra* note 26, at 937 ("Over time, riskier decisions produce greater profit, even after factoring losses, than do more conservative decisions."); Davis, *supra* note 17, at 575 ("Risky investments generally involve larger potential profits in exchange for the enhanced risk of loss."); *Gagliardi,* 683 A.2d at 1052 ("Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.").
[566] *Gagliardi,* 683 A.2d at 1052.
[567] *See* Allen, *supra* note 250, at 12 ("…absent protection from later liability, we might expect directors to be disinclined to accept much risk in new projects."); *Gagliardi,* 683 A.2d at 1052 ("…directors will tend to deviate from this rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to *ex post facto* claims of derivative liability for any resulting corporate loss."); *Disney*, 907 A.2d at 698 ("Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value.").
[568] *See* Davis, *supra* note 17, at 575; Eisenberg, *supra* note 168, at 445.
[569] Bainbridge, *supra* note 13, at 115 ("If liability results from bad outcomes, without regard to the ex ante quality of the decision or the decision-making process, however, managers will be discouraged from taking risks."); Davis, *supra* note 17, at 575 ("If corporate directors face personal liability in such circumstances they may steer away from risky courses of action, even though the course of action is, on the whole, in the best interests of the corporation and its shareholders."); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS cmt. c. to § 4.01(c) (1994) ("For efficiency reasons, corporate decision makers should be permitted to act decisively and with relative freedom from a judge's or jury's subsequent second-guessing. It is desirable to encourage directors and officers to enter new markets, develop new products, innovate, and take other business risks.").
[570] *See* Branson, *supra* note 213, at 637.
[571] *See* Lynch, *supra* note 358, at 454. The *Joy* court explained this point as follows:

> Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others.... A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.

would be greater than the losses arising from risky investments.[572] The business judgment rule facilitates corporate risk-taking by protecting directors from being liable for unfortunate outcomes of their decisions.[573] The rule's protection ensures that directors do not deviate from rational acceptance of risk-taking because of the fear of personal liability. Once directors have made an informed, honest, and disinterested decision, the business judgment rule requires courts to respect the directors' judgment and prevents them from imposing liability for the bad outcomes of such decisions. Thus, the rule creates a safe environment for directors to make "bold but desirable decisions."[574]

4. The Business Judgment Rule as a Presumption in Delaware

a. Methods of Rebutting the Presumption

In Delaware, the business judgment rule 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."[575] As a procedural guide for litigants, "the business judgment presumption is a rule of evidence that places the initial burden of proof on the plaintiff."[576] A plaintiff shareholder has the burden to rebut the presumption by establishing facts showing that a board decision lacks at least one element of the business judgment rule.[577] The party challenging the decision must prove by a preponderance of the evidence that the presumption of the business judgment rule is inapplicable either because the directors made an "unintelligent or unadvised judgment" or acted in bad faith, or that the directors had a financial interest in the subject matter of the decision.[578]

A plaintiff attacking the informational element of the business judgment rule must show that the directors failed to inform themselves of all material information reasonably available to

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Joy, 692 F.2d at 885–86.

[572] *See* Lynch, *supra* note 358, at 454; *see also Joy,* 692 F.2d at 885 ("…it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions ....").

[573] *See* Hecker, *supra* note 26, at 937 ("The business judgment rule … attempts to free directors from the fear of personal liability if a decision that appeared to be a reasonable risk at the time turns out badly."); Davis, *supra* note 17, at 575 ("The BJR responds to this problem of perverse incentives by assuring directors that courts will not delve too deeply into the soundness of their decisions."); Eisenberg, *supr*a note 168, at 445 ("…directors might tend to be unduly risk-averse, because if a highly risky decision had a positive outcome the corporation but not the directors would gain, while if it had a negative outcome the directors might be required to make up the corporate loss. The business judgment rule helps to offset that tendency.").

[574] Eisenberg, *supr*a note 168, at 445.

[575] *Aronson,* 473 A.2d at 812.

[576] Cinerama Inc. v. Technicolor Inc., 663 A.2d 1156, 1162 (Del. 1995).

[577] *Aronson,* 473 A.2d at 812.

[578] *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 756 (Del. Ch. 2005).

them before making the decision.[579] A plaintiff must show the directors' failure to make a reasonable effort to prepare themselves to make a decision. For example, a plaintiff may rebut the informed business judgment presumption by establishing that the directors approved a major corporate transaction without receiving and reviewing any expert advice, without receiving and reviewing a written summary of the proposed transaction, and without discussing and considering material facts or terms related to the transaction.[580]

To establish a failure to act in good faith, a plaintiff may prove the directors acted with subjective bad faith: an actual intent to harm the corporation; a purpose other than advancing the best interests of the corporation; or the intent to violate applicable positive law. Alternatively, the plaintiff may show that the directors intentionally failed "to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[581] Such conduct constitutes obvious, but not exclusive, examples of bad faith. As the Delaware Chancery Court stated, "there may be other examples of bad faith yet to be proven or alleged."[582]

The plaintiff may also rebut the business judgment presumption by proving the existence of "the adverse self-interest of the directors or of related persons to the interest of the corporation."[583] The plaintiff must show either that a director stands on both sides of a transaction or that a director receives a personal benefit from a transaction not received by the shareholders generally.[584] Also, a plaintiff may rebut the business judgment presumption by showing lack of director independence. In order to do so, a plaintiff must to show that a director receives a substantial benefit from supporting a transaction or that the director's judgment is based on personal or extraneous considerations rather than the corporate merits of the transaction.[585] If the plaintiff can prove the existence of self-dealing or the lack of independence,

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[579] *Aronson,* 473 A.2d at 812.
[580] *See* Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).
[581] *Disney*, 907 A.2d at 755.
[582] *Id.* at 756.
[583] *Aronson,* 473 A.2d at 812.
[584] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993).
[585] *Id.* at 362. *See also Cinerama,* 663 A.2d at 1167. The *Cinerama* court stated that, to rebut the presumption of director independence in an arms-length transaction, the plaintiff must show that the personal benefit the director receiving is material. The test of materiality involves a subjective "actual person" standard. Accordingly, under the test of materiality, "[it] would be required to determine *not* how or whether a reasonable person in the same or similar circumstances ... would be affected by … [the personal benefit], but whether *this* director in fact was or would likely be affected." *Id.* (emphasis in original).

and if the transaction in question is not approved by a majority of the disinterested directors or shareholders, the business judgment presumption will not apply.[586]

b. Effect of Rebutting the Presumption: Entire Fairness Standard

If the party challenging the directors' decision succeeds in rebutting the business judgment rule presumption, the burden shifts to the defendant directors to demonstrate that the transaction was entirely fair to the corporation and its shareholders.[587] If the directors' conduct failed to satisfy at least one element of the rule, they will lose the substantive protection attached to the business judgment presumption.[588] Accordingly, courts will review the directors' decision under the strict standard of entire fairness when the business judgment rule is rebutted. In an entire fairness review, courts exercise a thorough examination of both the process and substance of a decision.[589]

The rebuttal of the business judgment presumption and subsequent application of the entire fairness standard along with the shifting of the burden of proof "does not create per se liability on the part of directors."[590] Still, it places a difficult burden on the part of directors to convince the court that the decision in question is entirely fair to the corporation. Under the business judgment rule, the substance of a decision is immunized from judicial review. The entire fairness standard, on the other hand, includes a searching review of the substantive merits of a decision as well as the process by which that decision was reached. The entire fairness standard requires an "exacting scrutiny to determine whether the transaction [or the decision] is entirely fair to the stockholders."[591] Thus, as the business judgment rule is a difficult obstacle for a plaintiff to overcome, the entire fairness standard creates equal difficulties for the directors seeking to avoid personal monetary liability.

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[586] *See* DEL. CODE ANN. tit. 8, § 144(a). *See also Cinerama*, 663 A.2d at 1168. A material interest of one or more directors less than a majority of those voting would rebut the application of the business judgment rule if the plaintiff proved that "the interested director *controls* or *dominates* the board as a whole or [that] the interested director *fail[ed] to disclose his interest* in the transaction to the board *and* a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction." *Id*. (emphasis in original).
[587] *Disney*, 906 A.2d at 52; *Cede,* 634 A.2d at 361.
[588] *Cede*, 634 A.2d at 368.
[589] *Id*. at 361.
[590] *Id*. at 371.
[591] Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994).

The entire fairness standard has two basic components; fair dealing and fair price.[592] The fair dealing component relates to "how the board action was initiated, structured, negotiated, and timed."[593] The fair price component concerns "the economic and financial considerations of the proposed decision."[594] Under the entire fairness standard of review, "the defendant directors must establish to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price."[595] In *Weinberger v. UOP, Inc.,* the Delaware Supreme Court explained the entire fairness standard as follows:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed 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. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a non-fraudulent transaction we recognize that price may be the preponderant consideration outweighing other features of the merger.[596]

The entire fairness standard was originally designed to review self-dealing corporate transactions in Delaware law. In *Cede v. Technicolor*, the Delaware Supreme Court expanded the realm of the entire fairness standard to include judicial inquiry where the business judgment rule is rebutted for reasons other than adverse financial interest. The court held that, if a plaintiff overcomes the business judgment rule by proving that "directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care,"[597] the burden shifts to defendant directors to prove the entire fairness of the transaction.[598] Therefore, in the decision-making context, there are two applicable standards of review: the business judgment rule and entire fairness. Thus, a directors' challenged decision is initially subject to business judgment review, but if the business judgment rule is rebutted, the decision is reviewed under the entire fairness standard.

Accordingly, if a plaintiff shows that directors made a decision in a grossly negligent manner, the process and the substance of the decision are both subject to judicial review under

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592 Int'l Telecharge, Inc. v. Bomarko*,* 766 A.2d 437, 440 (Del. 2000).
593 *In re* Digex, Inc. S'holders Litig.*,* 789 A.2d 1176, 1207 (Del. Ch. 2000).
594 *Id.*
595 *Cede*, 634 A.2d at 361 (citations omitted) (emphasis in original).
596 457 A.2d 701, 711 (Del. 1983).
597 *Cede*, 634 A.2d at 361.
598 *Id.*

the entire fairness standard. To rebut the business judgment rule, a plaintiff is not required to show damages and the proximate cause between the grossly negligent conduct and the damages. A showing of grossly negligent conduct is sufficient to overcome the business judgment rule. In *Cede*, the Chancery Court rejected the complaint on the ground that the plaintiff had the burden of proving the proximate cause and injury and had failed to do so.[599] The Delaware Supreme Court reversed. Relying on *Van Gorkom*, the court stated that a showing of a breach of the duty of care by a grossly negligent process is sufficient to rebut the business judgment rule.[600] The court observed: "Requiring a plaintiff to show injury through unfair price would effectively relieve director defendants found to have breached their duty of care of establishing the entire fairness of a challenged transaction."[601] Therefore, the directors' decision is subject to judicial scrutiny under the fairness standard if it is made by a grossly negligent process without more.

The *Cede* court's holding that required the entire fairness standard in reviewing a disinterested decision or transaction where the business judgment rule is rebutted has been extensively criticized by commentators.[602] Commentators stated that before *Cede*, alleged breaches of the duty of care and duty of loyalty were reviewed under different standards, and if there was a breach of the duty of care, the burden of proof fell upon the plaintiff to show resulting injury.[603] The *Cede* court "changed [the] clear demarcation by which duty of care and duty of loyalty claims are reviewed." After *Cede*, "all a plaintiff need show is a breach of the duty of care, irrespective of any resulting harm, to trigger the far more liability threatening procedural consequences of changing the review standard to the more exacting entire fairness

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[599] Cinerama, Inc. v. Technicolor, Inc., 1991 Del. Ch. LEXIS 105, at *57 (Del. Ch. June 21, 1991) (relying on Barnes v. Andrews, 298 F.614 (S.D.N.Y. 1924) (involving a tort action)).

[600] *Cede*, 634 A.2d at 367–68 ("The Chancellor's restatement of the rule—to require Cinerama to prove a proximate cause relationship between the Technicolor board's presumed breach of its duty of care *and* the shareholder's resultant loss—is contrary to well-established Delaware precedent, irreconcilable with *Van Gorkom, …*") (emphasis in original).

[601] *Id.* at 369.

[602] *See, e.g.,* Johnson, *supra* note 251, at 638, 644, 648–49; Allen, Jacobs & Strine, *supra* note 208, 460–63. *But see* EISENBERG & COX, *supra* note 1, at 623. Professor Eisenberg took a moderate approach with respect to the *Cede* court's application of the entire fairness standard in the duty of care context. He observed as follows:

> If the conditions of the business judgment rule are not satisfied, then the standard by which the quality of a decision is reviewed is comparable to the standard of conduct for making the decision—that is, the standard of review is based on entire fairness or *reasonability*. This is nicely illustrated by the Delaware Supreme Court's decision in *Cede & Co. v. Technicolor*, Inc., in 1993.

Id. (citation omitted) (emphasis added).

[603] Allen, Jacobs & Strine, *supra* note 208, at 460.

scrutiny."[604] The entire fairness standard not only shifts the burden from the plaintiff to the defendant directors, but it also entails an exacting judicial review into the substance of a decision. One commentator stated: "*Cede* punctures the protective shelter of the business judgment rule by invasively scrutinizing for fairness the substance of director decisions in a duty of care case involving the exercise of business judgment."[605] Therefore, "[t]he *ex post* judicial review standard of fairness … is more demanding than the *ex ante* duty to act with care."[606] Commentators also stated that the entire fairness standard would have no utility in reviewing care cases not involving a specific transaction, because "due care cases in non-transactional settings … do not involve discrete market-based events that lend themselves to a fairness analysis."[607]

An alternative reading of the *Cede* holding may suggest that the Delaware Supreme Court in *Cede* attempted to reframe Delaware's duty of care law in accordance with the harsh criticism concerning the court's previous ruling in *Smith v. Van Gorkom*.[608] In *Van Gorkom*, the court found that defendant directors' decision-making process was grossly negligent, and therefore they were liable for the resulting damages.[609] Commentators criticized *Van Gorkom* holding for putting too much emphasis on process and disregarding substance.[610] Commentators further criticized *Van Gorkom* holding for disregarding subjective factors in the case, such as the business experience of directors or their familiarity with the corporation's financial status.[611]

In *Cede*, the court decided to put an intermediate step between the grossly negligent conduct and the resulting liability. The court held that a decision that is reached by a grossly

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[604] *Id*. at 462.
[605] Johnson, *supra* note 251, at 638.
[606] *Id.* at 649.
[607] Allen, Jacobs & Strine, *supra* note 208, at 462.
[608] 488 A.2d 858 (Del. 1985).
[609] *Id.* at 893.
[610] *See, e.g.,* Quillen, *supra* note 198, at 498. Former Justice Quillen observed as follows:

> If the price in *Trans Union* had been $110 instead of $55, then most reasonable decision makers would have been comfortable with less information. The same is of course true with a $55 cash in hand price instead of a $45 price. Thus the particular decision option facing the decision maker has some bearing on the threshold issue. This connection plus the presumed business expertise of the director suggest that the duty of inquiry should have both an objective and a subjective nexus with need or desirability. The 'all material information reasonably available' test of *Trans Union* puts the emphasis on access rather than need or desirability.

Id. *See also* Branson, *supra* note 213, at 632 ("By placing a premium upon the process that directors follow to reach a decision, rather than the resulting decision itself, the business judgment rule serves as a vibrant illustration of process engineering and the attorney's role in it.") .
[611] *See infra* Part E.1.a.

negligent process should be subject to fairness review before courts impose liability for damages. The entire fairness standard includes certain flexibility for courts to review directors' conduct in the decision-making context.[612] In fairness review, courts examine both the decision-making process and the resulting decision in its entirety. *Cede II* analysis shows that, the entire fairness standard includes an examination of the decision-making process along with the special circumstances of the case and the subjective factors related to the defendant directors. For example, in *Cede II*, the court considered the factor that the CEO of the company, who led the negotiations in the merger process, was an experienced CEO, and he was highly familiar with the prospects of the company.[613] Accordingly, the entire fairness standard requires an examination of all aspects of a decision, including the individual experience of directors and the special circumstances under which they made their decision. Furthermore, courts in fairness review give substantial weight to directors' judgment if they acted in good faith to further the best interests of the corporation.[614] Similarly, courts give substantial weight to directors' judgment if the transaction in question was initiated in arms'-length bargaining.[615]

Accordingly, fairness review gives directors an opportunity to avoid liability even though their decision-making process is grossly negligent. In other words, if the decision-making process does not satisfy the objective gross negligence standard, directors are provided a chance to convince the court under substantive (and subjective) fairness review. Therefore, lending an ear to the criticism concerning the *Van Gorkom* holding, the *Cede* court gave directors an opportunity to discuss different aspects of their decision-making process and the resulting decision in its entirety. Instead of automatically imposing liability for grossly negligent conduct, the court employed the entire fairness standard for determining whether directors' grossly negligent conduct nevertheless may be subject to judicial deference under the special circumstances of the case.[616]

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[612] *See, e.g.,* Nixon v. Blackwell, 626 A.2d 1366, 1381 (Del.1993) (stating that entire fairness review is "not in the nature of a litmus test that lends itself to bright line precision or rigid doctrine"); *Cinerama,* 663 A.2d at 1179 ("'perfection is not possible, or expected' as a condition precedent to a judicial determination of entire fairness"' because "the entire fairness standard is not even applied unless the presumption of the business judgment rule has been rebutted"); Byelick v. Vivadelli*,* 79 F.Supp.2d 610, 629 (E.D. Va. 1999) ("No inflexible rule has been established by which to test the 'fairness' of a transaction.").
[613] *Cinerama*, 663 A.2d at 1178.
[614] *Id*. at 1174.
[615] *Id*. at 1172.
[616] Nevertheless, the *Cede* court put a difficult burden on the defendant directors to prove the entire fairness of a decision. Furthermore, the entire fairness standard includes a review of the substantive merits of a decision, and such

Alternatively, the *Cede* holding may be seen as an attempt by the Delaware Supreme Court to reframe Delaware's fiduciary analysis under the business judgment rule after legislative developments in the field of the duty of care. As a response to *Van Gorkom*, the Delaware legislature amended its corporation law to add section 102(b)(7).[617] This section allows corporations to adopt charter provisions eliminating directors' monetary liability for due care violations. After the enactment of section 102(b)(7), corporations quickly adopted charter provisions to eliminate directors' personal liability for duty of care breaches. Therefore, the duty of care no longer provided a legal basis for director liability. In the presence of an exculpatory provision, directors may be held monetarily liable only for loyalty or good faith breaches.

Accordingly, it was expected that the plaintiffs' bar would modify its approach and litigate due care claims either under good faith or the duty of loyalty.[618] In that environment, the *Cede* court held that the applicable standard is entire fairness where the business judgment rule is rebutted by a showing that directors breached any *one* of their fiduciary duties—good faith, loyalty, or due care.[619] In so holding, *Cede* unified the judicial standard of fiduciary review under the business judgment rule. Therefore, if a plaintiff rebuts the business judgment rule presumption by showing a breach of any of the duty of care, good faith, or loyalty, the applicable standard is entire fairness with the burden on the defendants to demonstrate that their decision was made in good faith and in the best interests of the corporation. Professor Hecker explained this point as follows:

> [The *Cede* court] held that if the business judgment rule is rebutted because that process was grossly negligent, the case would be tried under the entire fairness standard with the burden of proof on the directors to establish that their decision was made in good faith and in the best interests of the corporation. In so holding, the *Cede* court was amazingly prescient, because after *Disney* and *Stone*, monetary liability is predicated on lack of good faith, which sounds in loyalty. In the decision-making context, if the plaintiff rebuts the business judgment rule in any of the three applicable ways, the case appropriately is tried under the entire fairness loyalty standard. If the business judgment rule is not rebutted the plaintiff must show waste, which is a decision so

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review may not be desirable in the duty of care context. Alternatively, it may be suggested that the judicial review of directors' decision-making process should include an examination of the special circumstances of the case. For example, PCG Section § 4.01(c)(2) requires directors to be "informed with respect to the subject of the business judgment to the extent the director … *reasonably believes* to be appropriate under the circumstances." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c)(2) (1994). Here, the term "reasonably believes" refers to both an objective and subjective content. Accordingly, "[i]n evaluating what is a reasonable belief in a particular situation, the 'informed' requirement in § 4.01(c)(2) should be interpreted realistically and with an appreciation of the factual context in which the business judgment was made." PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 cmt. e to § 4.01(c).

[617] *See* DEL. CODE ANN. tit. 8, § 102(b)(7). For a detailed explanation of section 102(b)(7) *see infra* Part E.2.a.

[618] *See infra* Chapter IV.B.2.

[619] *Cinerama*, 663 A.2d at 1179.

> reckless and irrational that it is explainable only on the basis of bad faith, which again is a loyalty breach….If, on the other hand, the factual situation is one of oversight, it has been clear since *Caremark* that the standard is lack of good faith, which after *Stone*, also is the duty of loyalty.[620]

Thus, the *Cede* court unified the standard of review under which courts examine a director decision where the business judgment rule is rebutted.

D. The Standard of Review: Monitoring/Oversight

The business judgment rule protects only director action; it has no application "where directors have either abdicated their functions, or absent a conscious decision, failed to act."[621] A deliberate decision not to act may enjoy the rule's protection, but simple inaction resulting from ignorance is not within the scope of the rule.[622] The purpose of the rule's protection is to encourage directors to act and perform their functions without fear of personal liability. Protecting directors from dormancy or from failure to act would not serve that purpose. Thus, as Judge Winter stated, "the business judgment rule extends only as far as the reasons which justify its existence",[623] and it is inapplicable to cases that involve unconsidered director inaction.

Accordingly, the business judgment rule is not applicable to cases in which directors have failed to exercise oversight over corporate affairs. In the oversight context, director liability may arise "from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss."[624] The alleged fiduciary breach in that context involves director nonfeasance rather than a business judgment, and there is no policy or fairness reason which justifies business judgment rule protection for this type of director conduct.[625] If, for example, directors received but did not review financial reports over a period of time, and thus allowed corporate funds to be looted by executives, the protection of the rule would be

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[620] Hecker, *supra* note 26, at 954–55.
[621] *Aronson*, 473 A.2d at 813.
[622] Rabkin v. Philip A. Hunt Chemical Corp. 57 A.2d 963, 972 (Del. Ch. 1986), *reargument denied,* 1987 Del. Ch. LEXIS 522, 1987 WL 28434 (Del. Ch. Dec. 17, 1987).
[623] Joy v. North*,* 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied,* 460 U.S. 1051 (1983).
[624] *Caremark*, 698 A.2d at 967 (emphasis in original).
[625] *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) cmt. c. (1994) ("There is, however, no reason to provide special protection where no business decision making is to be found. If, for example, directors have failed to oversee the conduct of the corporation's business, by not even considering the need for an effective audit process, and this permits an executive to abscond with corporate funds, business judgment rule protection would be manifestly undesirable."); Arsht, *supra* note 15, at 112 ("Where the charge is that by reason of inexcusable unawareness or inattention the directors failed to take corrective or preventive action toward matters about which something should have been done to prevent harm to the corporation or its stockholders, the business judgment rule provides no defense. Such a charge involves the failure to act, not the exercise of any judgment...But having made no deliberate decision, the defense that directors are not liable for honest mistakes of judgment is not available in such cases.").

undesirable.[626] However, the board's decisions "as to the specifics regarding implementation of its oversight functions" are subject to the business judgment presumption.[627] For example, if directors exercised a judgment to employ a reporting and information system to ensure legal compliance within the corporation, the adequacy of such system will be reviewed under the business judgment rule.

The question arises then, in the absence of the business judgment rule, what standard of review is applicable to determine liability for alleged director inaction. A single Delaware Chancery opinion answered this question by concluding that "ordinary negligence is the appropriate standard of liability in director neglect claims."[628] Likewise, the American Law Institute adopted ordinary negligence as the appropriate standard to review director conduct in situations of "omission."[629] The idea behind this position is that if directors' conduct does not qualify for the rule's protection, it should be subject to the default due care standard of ordinary negligence rather than the lenient standard of gross negligence, which is afforded to directors in reviewing the decision-making process under the business judgment presumption.[630]

The prevalent view in Delaware, however, appears to suggest that gross negligence is the appropriate standard in the oversight context as well. In *Graham v. Allis-Chalmers*

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[626] *See* PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. c.

[627] Hecker, *supra* note 26, at 938. *See also Caremark*, 698 A.2d at 969 ("Obviously the level of detail that is appropriate for such an information system is a question of business judgment."); PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. c. (stating that the directors' informed decision not to install an oversight program on a specific matter is protected by § 4.0l(c)).

[628] *Rabkin,* 1987 LEXIS 522, at *10.

[629] PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. c. (stating that in omission situations, the directors' conduct would be reviewed under the reasonable care standards of § 4.01(a) and not protected by § 4.0l(c)).

[630] The *Rabkin* court explained this point as follows:

> The question remains whether the standard of care applied to directors who attempt to exercise their business judgment also applies to those who abdicate their managerial responsibility in whole or in part. I think not. As I read *Smith v. Van Gorkom, supra* and the cases cited therein, the gross negligence standard is really a corollary to the business judgment rule. As the Court noted in *Van Gorkom*, '[t]he business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.' Consistent with the wide latitude granted to them under the business judgment rule, directors who undertake their decision making responsibility will not be held liable either for a fault in the decision making process or the decision itself unless they were grossly negligent. It does not seem logical to accord the same deference to directors who abdicate their managerial responsibilities. There would be little meaning to the business judgment rule if, in cases not implicating the duty of loyalty, directors were given the same protection from liability whether it applies or not.

Rabkin, 1987 Lexis, at *9-10 (citations omitted); *see also* Arsht, *supra* note 15, at 112 ("In such cases, the appropriate inquiry is simply whether the directors acted with the degree of care required of them in the discharge of their duties.").

Manufacturing Company,[631] decided long before *Rabkin*, the Delaware Supreme Court prescribed a lenient standard to review alleged oversight failure of directors. In *Graham*, the plaintiff claimed director liability for damages which company suffered as a result of antitrust violations.[632] The plaintiff asserted that directors were liable due to failure to take reasonable steps to discover and prevent the unlawful conduct.[633] The *Graham* court began its analysis by stating that directors are required to exercise ordinary care in managing corporate affairs.[634] The court added: "[W]hether or not by neglect [directors] have made themselves liable for failure to exercise proper control depends on *the circumstances and facts* of the particular case."[635] While the court's statement of the directors' duty of care suggested the ordinary negligence standard, its subsequent analysis indicated that something more than ordinary negligence was necessary to hold directors liable in an oversight failure. The court stated:

> In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.[636]

In several cases after *Graham*, with one exception,[637] Delaware courts held that gross negligence is the appropriate standard to determine liability in claims of director inaction or lack of oversight.[638] Similarly, commentators who examined Delaware case law in the oversight context observed that:

> With or without the business judgment rule (including its presumption), in order to recover money damages from a director for violation of the duty of care, the plaintiff must carry the burden of

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[631] 188 A.2d 125, 130 (Del. 1963); *see also* Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961) (finding non-affiliated directors liable for abdicating their responsibilities in a grossly negligent manner by paying no average attention to their duties).
[632] *Graham*, 188 A.2d at 127.
[633] *Id.*
[634] *Id*. at 130
[635] *Id.* (emphasis added).
[636] *Id*. *But see Aronson*, 473 A.2d at 812 n.7 (stating that *Graham* and *Lutz* do not present issues of business judgment although director liability in those cases have been adjudicated upon the business judgment rule); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 n.31 (Del. 1993) (stating that the *Graham* formulation is quite confusing and unhelpful because it speaks of prudent man standard but then it requires a reckless conduct for liability).
[637] *See supra* notes 628–30 & accompanying text.
[638] *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005) (stating that appropriate standard for determining liability for director inaction is widely believed to be gross negligence); Seminaris v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995) (stating that to hold directors liable the plaintiff is required to demonstrate that they were grossly negligent in failing exercise oversight); *In re* Baxter Int'l, Inc. S'holders Litig., 654 A.2d 1268, 1270 (Del. Ch. 1995) (implicitly accepting gross negligence standard by citing *Graham* and stating that plaintiff's claim in the oversight context did not meet the standard in *Graham*).

> proving, by a preponderance of the evidence, (i) the elements of violation of the duty of care and (ii) gross negligence.[639]

The policy reason underlying these decisions is that a demanding test of liability in the oversight context, as well as decision-making context, is necessary to encourage qualified persons to assume directorships in corporate boards.[640]

Nevertheless, if one considers the effect of exculpatory charter provisions for the duty of care, there remains little importance of a "negligence" standard in determining director liability in either the oversight or decision-making context.[641] Exculpatory provisions eliminate personal liability of directors for due care breaches in the oversight context as well as in the decision-making context. If a corporation's charter includes an exculpatory provision, the directors will only be responsible if their unconsidered inaction or lack of oversight reaches the level of failure to act in good faith. Accordingly, although directors are required to assure that an adequate information and reporting system exists within the corporation, a failure to do so may result in director liability only if it amounts to lack of good faith. The test of liability to determine a good faith breach in the oversight function is articulated in *Caremark.* There, the Delaware Chancery Court stated that "only a sustained or systematic failure of the board to exercise oversight" will establish the lack of good faith.[642] The Delaware Supreme Court approved the *Caremark* formulation in *Stone v. Ritter* and further explained the conditions that predicate director liability in the oversight context. The court stated that a lack of good faith can be found in the oversight context if:

> (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.[643]

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[639] Balotti & Hanks, *supra* note 378, at 1346; *see also* Veasey & Manning, *supra* note 460, at 928 (stating that the language of Delaware cases "supports the conclusion that the Delaware standard is gross negligence").

[640] *Caremark*, 698 A.2d at 971. Professor Hecker explains this point as follows:

> These decisions are supported, explicitly or implicitly, by the view that the policy of the law should be to encourage qualified people to assume directorships by freeing them from fear of liability for all but the grossest breaches of the duty of care.

Hecker, *supra* note 26, at 939. *See also* Davis, *supra* note 17, at 576 (stating that under "strong risk allocation rationale," the business judgment rule applies to director inattention as well).

[641] *See infra* Part E.2.a. (examining exculpatory provisions).

[642] *Caremark,* 698 A.2d at 971.

[643] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). The court also stated that the *Caremark* test is fully consistent with the Delaware Supreme Court's good faith test defined in *Disney*. *Id*. at 369.

Thus, since the advent of exculpatory charter provisions Delaware law has required a very demanding test of liability in the oversight context.

E. Exculpatory Charter Provisions

1. The Genesis: *Smith v. Van Gorkom* and Its Effects

   a. The Case

Smith v. Van Gorkom[644] is possibly the most famous Delaware case in the history of corporate fiduciary law. The Delaware Supreme Court in *Van Gorkom* held that, despite the absence of bad faith, fraud, illegality, or self-dealing, defendant directors were not protected by the business judgment rule because they failed to adequately inform themselves for their decision to approve the sale of the company.[645] In so holding, the court exposed directors to catastrophic personal liability. The court's holding shocked the business world. The Delaware legislature swiftly responded by enacting section 102(b)(7) of the Delaware General Corporation Law.[646] Section 102(b)(7) permits certificates of incorporation to contain a provision that exculpates directors from personal liability for monetary damages for a breach of the duty of care. The overwhelming majority of Delaware corporations have amended their charters to include such a provision. Thus, the holding of *Van Gorkom* resulted in the demise of the duty of care.

In *Van Gorkom*, the plaintiff shareholders claimed that the directors of Trans Union Corporation breached their duty of care in approving the cash-out merger of the company.[647] Jerome Van Gorkom, the chairman and chief executive officer of Trans Union, initiated the merger without informing or consulting other board members or senior management.[648] Van Gorkom approached his friend, Jay Pritzker, a famous corporate takeover specialist, with a proposal to sell the company at a price of $55 per share.[649] The price of $55 per share—a premium of approximately $20 over the company's market price—was based on rough calculations for the feasibility of a leveraged buy-out.[650] Pritzker showed interest in Van Gorkom's proposal and made a cash-out merger offer at $55 per share on the condition that the

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[644] 488 A.2d 858 (Del. 1985).
[645] *Id.* at 881.
[646] DEL. CODE. ANN. tit. 8, § 102(b)(7). For a detailed explanation of section 102(b)(7) *see infra* Part E.2.a.
[647] *Van Gorkom,* 488 A.2d at 863.
[648] *Id*. at 866.
[649] *Id.*
[650] *Id*.

Trans Union Board act on his offer within the following three days.[651] Pritzker also agreed to permit Trans Union to accept higher offers within 90 days, but he imposed substantial limitations on that extension.[652]

To obtain board approval, Van Gorkom called a special meeting without notifying the other directors concerning the subject matter of the meeting. He also called a meeting of senior management prior to the board meeting. No members of the board or senior management, except two officers, had any prior knowledge of the proposed merger. Most of the senior management, and especially the chief financial officer, responded negatively to the offer. The chief financial officer stated that price was too low, the timing was wrong, and the conditions of the offer would inhibit competing offers.[653] Notwithstanding objections by the senior officers, Van Gorkom proceeded to the board meeting.

Van Gorkom began the board meeting with a twenty-minute oral presentation explaining his efforts and Pritzker's subsequent offer. The chief financial officer attended the meeting to inform the board concerning his previous studies of a leveraged buy-out. He explained that his study was primarily prepared for a *feasibility* of a leveraged buy-out, and the study did not indicate a valuation for the company. He further explained that the study indicated a price of \$50-\$60 and \$55-\$65 per share, and the proposed price of \$55 for the cash-out merger was "in the range of a fair price," but "at the beginning of the range."[654] Van Gorkom stated that the 90 day market test would indicate if \$55 was a fair price.[655] An outside legal counselor, hired by Van Gorkom, advised the board that they might be sued if they did not accept the offer and that a fairness opinion was not required as a matter of law.[656] The board members did not receive and review the merger agreement or a written summary of it.[657] Without any further inquiry, the board approved the merger in that meeting upon two hours of consideration.[658]

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[651] *Id*. at 867.
[652] *Id.* Trans Union directors were permitted to accept higher offers within 90 days. However, the offer included the condition that Trans Union would permit Pritzker to buy 1,000,000 shares of Trans Union stock at \$38 which would deter higher bidders. The offer also included prohibitions against furnishing nonpublic information to other bidders and soliciting bids. *Id.*
[653] *Id.* at 867–68.
[654] *Id.* at 869.
[655] *Id.* at 868.
[656] *Id.*
[657] *Id.* at 874.
[658] *Id*. at 869. The board added to the proposed merger agreement the provision that the acquirer "acknowledges that Trans Union directors may have a competing fiduciary obligation to the shareholders under certain circumstances."

Subsequently, the company made a public announcement of the proposed merger. Soon after, a dissent arose over the merger agreement among senior management.[659] Van Gorkom met Pritzker to modify merger agreement to address the concerns of the senior management. Accordingly, Pritzker agreed to permit Trans Union to actively seek other offers, however, with serious constraints on the company's ability to negotiate with the potential bidders and to withdraw from the proposed merger agreement.[660] In a subsequent meeting, without receiving and reviewing the actual copy, the board approved the amended agreement upon oral discussion.[661] Therefore, the board failed to discover the actual implications of the amended agreement. Trans Union's efforts to solicit higher offers proved fruitless due to the constraint included in the amendment.[662] The board held a final meeting and voted to proceed with the proposed merger, which was approved in the subsequent shareholder meeting by 69.9 percent of the outstanding shares.[663]

The *Van Gorkom* court began its analysis by explaining the business judgment rule and the necessity of an informed business judgment for the protection of the rule. The court also emphasized that under section 251(b) of the Delaware General Corporation Law the defendant directors had a special duty to act in an informed and deliberate manner in the specific context of a merger.[664] The court concluded that the directors failed to reach an informed business judgment in a grossly negligent manner because they did not make an inquiry regarding intrinsic value of the company or regarding the adequacy of $55 per share price, they did not review the merger agreement or any written summary of it, and they approved the merger only upon two hours' consideration relying on Van Gorkom's twenty minute oral presentation, without prior notice, and without the exigency of a crisis or emergency.[665]

Id. at 879. The defendant directors claimed that this provision meant that they reserved the right to accept better offers and share nonpublic information with potential bidders. *Id.* at 869.

[659] *Id.*at 869.

[660] *Id*. at 870. The amendment included the condition that Trans Union could accept better offers from a third party only if the parties entered into a definitive agreement, not conditioned on financing or any other contingency. *Id*. at 884.

[661] *Id.* at 870.

[662] *Id.* General Electric Company showed interest in Trans Union; however they first requested the company to withdraw from Pritzker agreement. When Pritzker refused, General Electric terminated further discussions with Trans Union. *Id.* at 886 n.30.

[663] *Id.* at 870.

[664] DEL. CODE ANN. tit. 8, § 251(b).

[665] *Van Gorkom,* 488 A.2d at 874.

Furthermore, Van Gorkom and the other directors ignored the red flags raised by the chief financial officer against Pritzker's offer in the senior management and board meetings.[666] The price of $55 included a substantial premium over the market price. However, that alone was not a sufficient parameter to rely on because the directors knew that the market had consistently undervalued the worth of Trans Union's shares.[667] The court did not require the board to have an outside valuation study or to shop the company among competing bidders to exercise an informed business judgment.[668] Rather, the court simply required the board to have a credible basis for the adequacy of the proposed sale price. An inside or outside study concerning the intrinsic value of the corporation, or alternatively, an unfettered market test, would have provided a sound basis for determining the fair value of the company.[669] The Trans Union directors, however, approved the offer based on Van Gorkom's understanding of the substance of the merger agreement, which Van Gorkom himself had never read.[670]

Considering all these factors, the court held that the Tran Union directors failed to reach an informed business judgment to approve the proposed merger agreement.[671] The court further held that subsequent actions by the board, including the amendment of the original agreement to permit solicitation of other bids, did not cure the initial failure because the amendment included serious constraints of which directors were not aware.[672] Finally, the court held that the directors breached their duty of complete candor to shareholders by failing to disclose all material facts they knew, or should have known, and therefore, the shareholder approval did not cure the board's defective approval process.[673] The Delaware Supreme Court remanded the case to the

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[666] *Id* at 877. The court stated that if the board had made an inquiry of the chief executive officer, they would have discovered the inadequacy of the $55 per share price and other disadvantages of the offer. *Id*. *See* Stephen M. Bainbridge, Smith v. Van Gorkom*,* UCLA SCHOOL OF LAW, LAW & ECONOMICS RESEARCH PAPER SERIES No. 08-13, at 17 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1130972 (supporting the court's position by stating that disagreement among senior management raised questions about the fairness of the transaction). *But see* Quillen, *supra* note 198, at 479 (criticizing the court for drawing no inferences from the continuing interest of the senior management).
[667] *Van Gorkom*, 488 A.2d at 876 ("the adequacy of a premium is indeterminate unless it is assessed in terms of other competent and sound valuation information that reflects the value of the particular business").
[668] *Id.*
[669] Bainbridge, *supra* note 666, at 20–21.
[670] *Van Gorkom*, 488 A.2d at 874.
[671] *Id*. at 881.
[672] *Id.* at 884.
[673] *Id.* at 893.

trial court for a determination of damages based on "the extent that the fair value of Trans Union exceeds $55 per share."[674]

The court's holding received harsh commentary from prominent corporate scholars.[675] Even one of the dissenting justices of the case attacked the decision by labeling it as "comedy of errors."[676] The court's holding was often criticized for focusing on negative elements of the facts.[677] Commentators stated that the court did not give sufficient weight to the positive facts that the defendant directors were high caliber business persons with impeccable credentials;[678] they were acutely aware of the company's financial status and its prospects; Van Gorkom was highly familiar with the corporate environment, merger procedures, and valuation methods;[679] and the proposed sale price included a substantial premium over the market value. A former leading Delaware judge stated that "the opinion does not point to essence and is burdened by

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[674] *Id.*

[675] *See, .e.g.,* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after* Van Gorkom, 41 BUS. LAW. 1 (1985) ("The corporate bar generally views the decision as atrocious."); Fischel, *supra* note 537, at 1455 ("…*Smith v. Van Gorkom*, surely one of the worst decisions in the history of corporate law…"); Leo Herzel & Leo Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986) ("To most the court's decision seems misguided and Trans Union's actions entirely proper."); Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 478 (2000); Allen, Jacobs & Strine, *supra* note 208, at 458.

[676] *Van Gorkom*, 488 A.2d at 894.

[677] *See, e.g.,* Quillen, *supra* note 198, at 479 ("… negative inferences are drawn from superficial facts—such as the presence or absence of documents or the execution of documents at a social event").

[678] *Id.* at 469. "[I]t is essential, even in major business judgment decisions, to permit knowledgeable directors…to apply their general knowledge of the corporation's business and affairs to a specific transaction. In a real sense that is precisely why they are paid." *Id.*

[679] *See* Herzel & Katz, *supra* note 675, at 1188 ("Van Gorkom was a seasoned chief executive officer and substantial stockholder. He was well placed and motivated to strike a good deal, even when acting by himself."). Professor Fischel extensively criticized the court's negative emphasis on Van Gorkom's role in the transaction as follows:

> Several reasons existed for the directors to defer to Van Gorkom's advice concerning the merger. First, although all the directors were knowledgeable about Trans Union, Van Gorkom as its chairman and chief executive officer was presumably the most knowledgeable. Second, Van Gorkom had strong incentives to negotiate the best deal possible. The transaction was negotiated at arm's length; moreover, Van Gorkom was himself a large shareholder. The better the deal that Van Gorkom negotiated, the more money he made himself. Third, Van Gorkom was one year away from retirement and thus had no reason to block a merger in the interest of keeping his job….
>
> The court's discussion of Van Gorkom's actions in dealing with Pritzker is, if anything, even less persuasive than its criticism of the other directors. The court's decision implies that Van Gorkom did something wrong in bringing a complete sale and financing package to Pritzker rather than simply soliciting interest. But why does this conduct not instead demonstrate Van Gorkom's skill as a negotiator in putting together a deal and convincing the other party that the deal made sense from his perspective as well? Indeed, the facts as recited by the court demonstrate that Van Gorkom got Pritzker to accept a deal that Van Gorkom's own advisers told him was problematic for the purchaser and successfully resisted Pritzker's proposal of a lower price and certain other requested concessions.

Fischel, *supra* note 537, at 1445–46.

overkill and by needless, and often erroneous, legal and factual excess."[680] Daniel Fischel and Bayless Manning were highly critical of the courts' emphasis on the intrinsic (or fair) value of the company.[681] The court was also criticized for applying a strict standard to review the defendant directors' decision-making process.[682] According to commentators, the court, "while purporting to apply the gross negligence standard of review, in reality (but not explicitly) applied an ordinary negligence standard."[683] Commentators further criticized the *Van Gorkom* court for disregarding long-standing Delaware corporate policy to defer to the business judgment of directors who act in good faith.[684] Finally, commentators criticized the court for its lack of understanding of how businesses operate[685] and stated that the *Van Gorkom* holding in general will decrease the amount of risk-taking by corporate directors.[686]

Despite the harsh criticism, one would agree that the defendant directors in *Van Gorkom* acted with undue haste in approving the sale of the company, a transaction which possibly carries the greatest magnitude of importance in a corporation. On the other hand, the points that the critiques made would lead one to wonder if the defendants, who were attentive directors in general and acted in good faith to approve the sale of the company in particular,[687] deserved to be exposed to a potentially catastrophic personal liability. The unusual facts of the case, the disagreement concerning the court's holding, and the discomfort in resulting potential director liability leave no doubt that *Van Gorkom* was a difficult corporate law case. A long discussion

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[680] Quillen, *supra* note 198, at 474; *see also* Hamermesh, *supra* note 675, at 478 (criticizing the opinion on the same ground).
[681] Fischel, *supra* note 537, at 1451 (arguing that "the intrinsic value standard is vacuous"); Manning, *supra* note 675, at 4 (criticizing the concept of intrinsic value and naming it "as-if market value"); Bainbridge, *supra* note 666, at 17–18 ("The court's analysis in this regard is seriously flawed. As with any other asset, a company is worth only what somebody is willing to pay for it.").
[682] *See* Allen, Jacobs & Strine, *supra* note 208, at 458; Bainbridge, *supra* note 666, at 22.
[683] Allen, Jacobs & Strine, *supra* note 208, at 458.
[684] *Id*. at 449.
[685] Herzel & Katz, *supra* note 675, at 1189; Fischel, *supra* note 537, at 1455.
[686] Fischel, *supra* note 537, at 1453 ("Because the decision increases the probability that managers will be sued and held personally liable for damages, managers will naturally want to minimize their exposure by avoiding activities in which they are likely to be sued. They will be less willing to serve (the best protection against getting sued), and when they do serve, will overinvest in information and be less entrepreneurial.… Liability rules that reinforce this incentive will operate to shareholders' detriment.") (citations omitted).
[687] Put it another way, if there was a hypothetical *Van Gorkom* before the actual *Van Gorkom* case, and if the defendant directors knew that the court would closely review their decisional process concerning a disinterested and good faith decision, they would probably have been more careful in their decisional process. The directors, however, relying on the ambiguity surrounding the duty of care law before the 1980s, had confidence that their decision would have been protected by the business judgment rule. The *Van Gorkom* holding is often justified on the court's earlier ruling in *Aronson*, which required an informed decision for business judgment rule protection. However, *Aronson* was decided after the defendant directors in *Van Gorkom* completed the sale of the corporation.

concerning who was right or wrong as to the result in such a case may be fruitless. As the former Delaware justice, who wrote the majority opinion in the *Van Gorkom* case, observed in a later article:

> In the field of corporate law, a tough corporate case presents a fertile field for disagreement–in terms of a judge's goal of reaching what appears to be the correct result and then defining a means and course for attaining it.[688]

Perhaps, rather than focusing on the right-wrong aspect of the result, an analysis of *Van Gorkom,* along with the legal environment preceding the case, may be helpful in understanding the court's holding. In the duty of care context, Delaware's pre-*Van Gorkom* tradition "was highly deferential to decisions made by well-motivated corporate directors who acted without any conflicting self-interest."[689] Court decisions in cases that did not involve self-dealing suggested that the imposition of fiduciary liability would require a showing similar to bad faith.[690] The concept of the business judgment rule provided directors strong protection in the absence of bad faith and self-dealing. Furthermore, Delaware courts employed the business judgment rule concept often without providing a considered articulation of the relationship between the duty of care and the business judgment rule.[691] The abstract nature of the duty of care, strong protection provided directors under the business judgment rule, and the scarcity of Delaware decisions that required an informed decision under the business judgment rule created an ambiguity surrounding the duty of care.[692] This ambiguity caused a misconception that Delaware's business judgment rule overrode directors' fiduciary duty of care and, therefore, led many commentators to observe that Delaware courts "announced but did not enforce the duty of care."[693]

The misconception about Delaware's business judgment rule was accompanied by great dissatisfaction. Many commentators raised concerns regarding Delaware's highly-deferential corporate policy. Delaware courts were criticized for providing directors excessive protection under the business judgment rule and for not enforcing the duty of care.[694] Commentators increasingly called for federal chartering of corporations law to address Delaware's pro-

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[688] Horsey, *supra* note 230, at 972.
[689] Allen, Jacobs & Strine, *supra* note 208, at 450.
[690] *Id.*
[691] Horsey, *supra* note 230, at 981.
[692] *See supra* notes 246–53 & accompanying text.
[693] Allen, *supra* note 250, at 11.
[694] *See supra* notes 247–49 & accompanying text.

management corporate policy.[695] Furthermore, there was an increasing public trend toward director accountability, and corporate governance issues were receiving increasing attention from corporate shareholders.[696] The criticism of Delaware courts reached the point that prominent members of Delaware corporate bar reacted to defend Delaware law. Samuel Arsht, for example, stated that the business judgment rule was misunderstood, and the misunderstanding stemmed from Delaware courts' language.[697] Arsht attempted to address the misconception by explaining that the business judgment rule did not preclude judicial inquiry into due care; rather, directors were required to exercise due care to be afforded the rule's protection.[698] Similarly, the influential members of the General Corporation Law Committee of the Delaware State Bar Association issued a "Resource Document on Delaware Corporation Law" to address the criticism in a broader context, including Delaware decisional law in the field of the duty of care.[699] The authors of the document gave examples from Delaware decisions to explain that Delaware law required directors to pay "informed attention to their duties", and that "unadvised and unintelligent business judgment" was not protected under the business judgment rule.[700]

The Delaware Supreme Court did not delay to in responding doctrinal concerns regarding Delaware law. In *Aronson v. Lewis*, which provided the keystone for the *Van Gorkom* holding, the court expressly stated that, before making a decision, directors should inform themselves of all material information to invoke the protection of the business judgment rule.[701] Soon after, the court in *Van Gorkom* held that the directors' decision did not qualify for the protection of the business judgment rule due to their failure to make an informed judgment. Having lost business judgment rule protection, directors were exposed to multi-million dollar personal liability. In that environment, the *Van Gorkom* court may have been acting with a purpose to address increasing doctrinal and public concern regarding Delaware's duty of care law.[702] Accordingly, the *Van*

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[695] *See* Horsey, *supra* note 230, at 991–92 (summarizing the commentary which suggested corporate chartering under federal law); Arsht, *supra* note 15, at 100–01(same).
[696] *See* Stacy D. Blank, *Delaware Amendment Relaxes Directors' Liability*, 44 WASH. & LEE L. REV. 111, 118 n.60, 119, 128 (1987).
[697] Arsht, *supra* note 15, at 102.
[698] *Id.* at 114.
[699] *See generally Resource Document*, *supra* note 246.
[700] *Id.* at 186.
[701] *Aronson*, 473 A.2d at 812.
[702] *See* Horsey, *supra* note 230, at 996. Former Justice Horsey's overall evaluation of Delaware's duty of care law reflects this point. Horsey first examines Delaware decisional law before the 1980s and points out the lack of judicial consideration of the relationship between the duty of care and the business judgment rule. Horsey subsequently goes through the criticism of Delaware law and the Delaware bar's reaction. Horsey then implies that

Gorkom holding may be viewed as an attempt to revive the dormant duty of care of corporate directors. *Van Gorkom* sent corporate actors a clear message that uninformed business decisions would not be respected by Delaware courts.

Considering the aftermath of *Van Gorkom*, one may argue that a smooth transitional process would have been preferable to revive the dormant duty of care.[703] For example, after a finding of grossly negligent conduct, the court could somehow exonerate directors from catastrophic personal liability.[704] Indeed, directors' general sophistication in business, their

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the *Van Gorkom* decision was made as a response to doctrinal concerns regarding Delaware's duty of care law. For example, Horsey states: "Had Arsht's analysis of the shortcomings of the Delaware business judgment rule been heeded earlier, the decision of the supreme court in Smith v. Van Gorkom may have been more foreseeable." *Id.*

[703] *See* Thomas C. Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239, 249 (1988) ("[T]he Delaware Supreme Court appeared to go out of its way to use this case as a vehicle to revitalize the dormant duty of care doctrine.").

[704] In the common law, the general rule is that court decisions have retroactive effect. In other words, when courts make new law by deciding a case a certain way, that change is necessarily retroactive as to the parties involved in the case that makes the change, unless the court expressly says in the opinion that the new rule (or revived application of a dormant rule) will only apply prospectively to cases in the future. Although courts rarely make an exception to the general rule of full retroactivity, this is possible under certain circumstances. Lederman examined Michigan case law and gave examples of court decisions with limited retroactive or prospective effect. *See* HOWARD YALE LEDERMAN, JUDICIAL OVERRULING: TIME FOR A NEW GENERAL RULE, September 2004 Michigan Bar Journal 22 (2004), available at http://www.michbar.org/journal/pdf/pdf4article740.pdf. He observed: "For decades, [Michigan] appellate courts have applied certain decisions with limited or no retroactivity." *Id.* at 23. In Pike v. City of Wyoming, the Michigan Supreme Court noted: "In 1932, the United States Supreme Court ruled that the federal constitution does not inhibit state courts in determining whether their own law-changing decisions should be applied retroactively or prospectively." 431 Mich. 589, 603; 433 N.W.2d 768 (1988) (citing Great Northern R Co. v. Sunburst Oil & Refining Co., 287 U.S. 358 (1932)). Subsequently, the *Pike* court recognized a prospectivity exception and adopted a test, which was initially developed by the United States Supreme Court, to determine whether an overruling decision should apply prospectively. *Id.* at 603–4 (citing Chevron Oil Co v. Huson, 404 U.S. 97, 106–107 (1971)). In Michigan law, the test to determine retroactivity or prospectivity is not rigid: Michigan appellate courts "may also incorporate into [their] analysis any other facts or considerations relevant to the instant dispute that may affect the fairness of [the] determination." Sturak v. Ozomaro, 238 Mich. App. 549, 560; 606 N.W.2d 411, 418 (2000). "[R]esolution of the retrospective-prospective issue ultimately turns on considerations of fairness and public policy." Michigan Educational Employees Mutual Insurance Co. v. Morris, 460 Mich 180, 190; 596 N.W.2d 142, 147 (1999) (citation omitted). In Pohutski v. City of Allen Park, the Michigan Supreme Court held its decision prospective. 465 Mich. 675, 696–97; 641 N.W.2d 219 (2002). Lederman supports Michigan courts' approach and argues that "[f]ull retroactivity should not be the rule but the exception." LEDERMAN, *supra*, at 22. He observed as follows:

> The power to define the law implies the power to change the law. The power to change the law implies the power to define the new law's scope of application. The U.S. Constitution does not mandate any particular state law [prospective-retroactive] decisionmaking. For decades, appellate courts have applied certain decisions with limited or no retroactivity. Appellate courts have always performed two different functions: deciding cases and establishing and changing the rules governing and guiding future conduct. Accordingly, the Court's authority to decide how to apply its changes is broad.

Id. at 23 (footnotes omitted). Accordingly, in the common law, it is possible for courts to hold their decisions prospective. This would have been an appropriate situation for the *Van Gorkom* court to have done so. Or, alternatively, *Van Gorkom* could have pointed out the deficiencies in the defendant directors' decisional process but familiarity with the corporation's financial status, the substantial premium over the market price, and shareholder's approval could provide a sound basis to do so. In that way, while maintaining Delaware's corporate policy, the court could send a message to directors to make informed business decisions, and that at the behest of shareholders Delaware courts will closely review the directors' decisional process to determine whether they made an informative and deliberative decision. In the absence of the resulting liability, the court's holding would not attract such harsh criticism. Nevertheless, the court probably did not predict the potential effects of its holding in the duty of care law. Regardless who is right or wrong as to the ultimate holding, *Van Gorkom* took its place in Delaware corporate law history as possibly the most controversial case.

b. Aftermath of *Van Gorkom*: Director and Officer Liability Insurance Crises and Director Unavailability.

As one could predict from the harsh commentary,[705] the Delaware Supreme Court's holding in *Van Gorkom* shocked the corporate world. The court's holding showed that directors really could face personal liability for catastrophic corporate damages for the lack of due care even if they acted in good faith and had no conflict of interest. According to many, the decision significantly increased the liability risk of corporate directors.[706] The common feeling in the corporate world was that directors had become very susceptible to personal liability after *Van Gorkom*. Moreover, rising numbers of shareholder derivative suits and takeover claims increased the probability of adverse judgments and settlements.[707] As a result, a crisis arose in the director and officer (D&O) liability insurance market, and a sharp decrease in the availability of outside directors that followed this crisis.[708]

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nevertheless could have not found them grossly negligent due to the special circumstances of the case. In this way, without imposing personal liability, the court could have telegraphed to the directors of Delaware corporations that at the behest of shareholders Delaware courts would closely review the directors' decisional process to determine whether they made an informative and deliberative decision.

[705] Prominent scholars' harsh commentary may have contributed to the corporate chaos that allegedly the *Van Gorkom* holding caused. For example, instead of advising directors to be more attentive on corporate affairs, the commentary on *Van Gorkom* often focused on negative elements of the decision and predicted that the holding would have devastating effects in the corporate world. Although critiques might have valid reasons, these predictions may have had negative impact on corporate directors and the corporate environment. *See e.g.,* Manning, *supra* note 675, at 1 ("Commentators predict dire consequences as directors come to realize how exposed they have become."); Fischel, *supra* note 537, at 1453–54 (listing negative effects that the *Van Gorkom* holding will cause).

[706] *See* Manning, *supra* note 675, at 1; Fischel, *supra* note 537, at 1453.

[707] Blank, *supra* note 696, at 118.

[708] *See* Lee, *supra* note 703, at 254–55 (rejecting the popular view that legal system was the cause of D&O liability insurance crisis and arguing that the competition in the insurance market and mismanagement of the insurance companies caused the crisis); Stephan A. Radin, *The Director's Duty of Care Three Years after* Smith v. Van

The perception of increased liability threat for directors led dramatic changes in D&O insurance market.[709] It became very hard to obtain D&O liability insurance either because polices were not affordable or simply were not available at any price.[710] Many insurance companies terminated their D&O coverage or substantially altered their policies to limit the availability and scope of their coverage.[711] Premiums of available D&O policies skyrocketed and deductible amounts increased at an extraordinary rate.[712] Policy durations became shorter, and the number of restrictions and exclusions in the policies increased.[713] Many policies included early cancellation provisions[714] and excluded coverage for takeover violations and shareholder derivative claims.[715] Thus, the crisis in D&O insurance market was undoubtedly devastating.

Declining availability of D&O liability insurance increased the likelihood of director liability exposure even more. The shortage of adequate D&O coverage, which was a traditional means for directors to avoid personal liability,[716] put directors in an unduly risky position. In addition, there was a considerable growth in the number of shareholder derivative suits and

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Gorkom, 39 HASTINGS L.J. 707, 745 (1988) (stating that the *Van Gorkom* holding was one major but not the only cause of D&O insurance crisis).

[709] *See* E. Norman Veasey, Jesse A. Finkelstein & C. Stephen Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance,* 42 BUS. LAW. 399, 400–01 (1987); Lee, *supra* note 703, at 240–41; Bainbridge, *supra* note 666, at 2; Radin, *supra* note 708, at 745; Blank, *supra* note 696, at 117–18.

[710] Bainbridge, *supra* note 666, at 20; Lee *supra* note 703, at 253 (giving examples of extensive media news covering of D&O insurance liability crisis).

[711] *See* Veasey, Finkelstein, & Bigler, *supra* note 709, at 400–01; Blank, *supra* note 696, at 117; Radin, *supra* note 708, at 745; Lee *supra* note 703, at 253.

[712] Radin, *supra* note 708, at 745; Blank, *supra* note 696, at 117–18 (stating the premium rates of available D&O policies became fifteen to twenty times more expensive than previous rates); One commentator gives examples of the crisis as follows:

> By one account, prior to 1985, D&O premiums for large companies were often less than $200,000 for as much as $100 million of coverage. But in less than a year, premiums rose in some cases to $1 million for about half that coverage. A comparison study showed that in September, 1984, D&O insurance was available for losses not actually indemnified by the corporation, for a term of three years, at a premium rate which rarely exceeded 25% of the policy limit. It was a buyer's market. By contrast, in September 1986, D&O insurance was available only for nonindemnifiable losses, whether or not indemnified in fact, for a term of twelve months, at a premium rate of 5% of the policy limit, with higher levels demanded in higher-risk industries; indeed, it was a seller’s market.

Lee, *supra* note 703, at 253 (citations omitted).

[713] Radin, *supra* note 708, at 745; Lee *supra* note 703, at 253.

[714] Radin, *supra* note 708, at 745 (stating that insurers imposed early cancellation provisions to bail out of difficult situations).

[715] Blank, *supra* note 696, at 118; Lee *supra* note 703, at 253.

[716] *See* Blank, *supra* note 696, at 118; Lee *supra* note 703, at 255 (discussing and criticizing the propriety of D&O liability insurance).

takeover claims, and courts arguably became more willing to scrutinize director decisions.[717] In the absence of liability protection in such a litigious corporate environment, directors basically assumed all responsibility for potential corporate losses resulting from their faulty decisions. Considering the potentially catastrophic amounts of corporate damages, and probability of unintended wrongdoing when making complex business judgments, directors were under serious threat of loss of their personal wealth.

Not surprisingly, the fear of personal liability soon became widespread among corporate directors. Many incumbent directors resigned or refused to extend their directorships.[718] Prestigious board positions became very burdensome and many qualified individuals were unwilling to serve as corporate directors.[719] The potential consequences of being a director in large public corporations deterred competent candidates from accepting board memberships. This was especially true of potential outside directors, who refused to serve on boards because they had to risk their personal assets in exchange for small directorship fees.[720] Outside director unavailability raised serious concerns regarding the functionality of monitoring boards. Moreover, the lack of adequate protection naturally caused many directors who remained on boards to behave with unprecedented caution and, therefore, to avoid risky business activities.[721] Thus, imaginary or real, the increased judicial threat of director liability resulted in undesired difficulties in the corporate world.

2. The Legislative Response: Section 102(b)(7) and Its Interpretation by the Courts
    a. Charter Provisions Exculpating Directors from Liability for Money Damages for Breach of Duty of Care but Not for Acts or Omissions Not in Good Faith

The Delaware legislature responded to the Delaware Supreme Court's holding in *Van Gorkom*, and to the subsequent D&O liability insurance crisis and director depletion problem, by amending its corporate law to add section 102(b)(7).[722] This section allows Delaware

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[717] Blank, *supra* note 696, at 118; Roberto Romano, *The Shareholder Suit: Litigation without Foundation?* 7 J.L. ECON. & ORG. 55, 58 (1991).
[718] *See* Radin, *supra* note 708, at 745; Blank, *supra* note 696, at 118.
[719] *See* Radin, *supra* note 708, at 745; Blank, *supra* note 696, at 118.
[720] *See* Blank, *supra* note 696, at 133; Lee, *supra* note 703, at 241, 256.
[721] *See* Radin, *supra* note 708, at 745; Blank, *supra* note 696, at 118.
[722] DEL. CODE ANN. tit. 8, § 102(b)(7). The Delaware Supreme Court in *Emerald Partners v. Berlin* described section l02(b)(7) as "a thoughtfully crafted legislative response to [the] holding in *Van Gorkom.*" 787 A.2d 85, 96 (Del. 2001); *See also* Malpiede v. Townson, 780 A. 2d 1075, 1095 (Del. 2001) ("Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*."); *see also* Blank, *supra* note 696, at 118 (stating that, in

corporations to include a provision in their certificate of incorporation limiting or eliminating directors' liability for monetary damages for breach of fiduciary duty, but excluding: (1) any breach duty of loyalty; (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (3) unlawful payment of dividends or unlawful stock purchases or redemptions; and (4) transactions from which the director derived an improper personal benefit.[723] In other words, the statute authorizes shareholders to adopt a provision in the certificate of incorporation to free directors from personal liability for money damages for breach of the duty of care.[724] The statute applies only to directors of a corporation, not to officers or other employees of the corporation.[725]

More specifically, the statute immunizes directors from grossly negligent conduct.[726] Prior to the statute, the business judgment rule protected directors from ordinary negligence in exercise of the duty of care.[727] However, under the business judgment rule, directors remained liable for breach of the duty of care arising from grossly negligent conduct. After the enactment of section 102(b)(7), directors are protected from all negligence.[728] Furthermore, directors are protected from monetary liability for due care breaches arising from unconsidered inaction or failure to perform their oversight function. Thus, where the business judgment rule protection is unavailable, directors will be protected from liability by an exculpatory charter provision so long as their action does not fall within one of the exceptions contained in section 102(b)(7).[729]

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addition to addressing insurance crisis, the enactment of new section was a part of the Delaware legislature's continuous efforts to relax corporate liability of businesses and managements); Lee, *supra* note 703, at 256 (criticizing Delaware's response to the crisis as inappropriate).

[723] DEL. CODE ANN. tit. 8, § 102(b)(7).

[724] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006).

[725] DEL. CODE ANN. tit. 8, § 102(b)(7). *See* McPadden v. Sidhu, 964 A.2d 1262, 1275 (Del. Ch. 2008) ("Though an officer owes to the corporation identical fiduciary duties of care and loyalty as owed by directors, an officer does not benefit from the protections of a Section 102(b)(7) exculpatory provision, which are only available to directors."); Arnold v. Soc'y for Sav. Bancorp. Inc., 650 A.2d 1270, 1288 (Del. 1994) ("where a defendant is a director and officer, only those actions taken solely in the defendant's capacity as an officer are outside the purview of Section 102(b)(7)"); *Disney,* 907 A.2d at 771 n.560 (stating that the actions subject to the complaint were taken by defendants in directorial capacity, and therefore their officer status is irrelevant in terms of section 102(b)(7) charter provision); *see also* Radin, *supra* note 708, at 747 (noting that drafters did not believe that D&O liability insurance crisis was sufficient to cause officers to resign or refuse to serve).

[726] *Malpiede,* 780 A.2d at 1094–95 ("[E]ven if the plaintiffs had stated a claim for gross negligence, such a well-pleaded claim is unavailing because defendants have brought forth the Section 102(b)(7) charter provision that bars such claims.").

[727] See *supra* Part C.1.a

[728] *See* Blank, *supra* note 696, at 119.

[729] *Id.*

Regardless of exculpatory provisions, directors are personally liable "for wrongful conduct going beyond duty of care violations."[730] Section 102(b)(7) expressly excludes a loyalty breach and lack of good faith from exculpable conduct. A charter provision may exculpate directors from monetary liability for breach of the duty of care but not for acts or omissions not in good faith. Accordingly, section 102(b)(7) allows elimination of director liability only for "conduct undertaken in good faith, but which nevertheless constitutes breach of the duty of care."[731] If a breach of the duty of care is so egregious that it amounts to the level of bad faith, it will not be protected by a section 102(b)(7) charter provision. For example, a director will likely be liable for knowing violation of the duty of care regardless of an exculpatory charter provision because intentional dereliction of a duty constitutes bad faith. Thus, section 102(b)(7) maintains a minimal level of fiduciary conduct even though directors are exempted from due care liability.

Technically, section 102(b)(7) permits only limitation or elimination of the monetary damage remedy, not the duty of care itself.[732] Equitable remedies such as injunctive relief remain untouched.[733] However, nonfinancial remedies "have only limited applications and thus cannot serve as an adequate substitute for financial liability, in part because due care suits typically arise well after the event."[734] Injunctive remedies normally are not effective means to enforce the duty of care.[735] Without financial liability, directors may tend to ignore their due care responsibilities because all that shareholders can ask a court to do is to stop or rescind the offending transaction. Indeed, shareholders rarely seek to enjoin a corporate transaction claiming a breach of the duty of care.[736] Therefore, practically, the duty of care without financial liability has greatly reduced importance.[737]

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730 *Arnold*, 678 A.2d at 541–42.
731 Radin, *supra* note 708, at 744.
732 *See Emerald Partners,* 787 A.2d at 92 ("[A] Section 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits," but "it can operate to defeat the plaintiff's ability to recover monetary damages."); Hecker, *supra* note 26, at 941 n.103; Radin, *supra* note 708, at 747.
733 Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) ("Such a charter provision, when adopted, would not affect injunctive proceedings based on gross negligence.").
734 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 Rep.'s note 2. (1994).
735 *See* Lee, *supra* note 703, at 274 (discussing that injunctive remedies are inadequate due to their lack of deterrence value).
736 *See* Hecker, *supra* note 26, at 941 n.103 ("As a practical matter, one would not expect to encounter many cases in which a plaintiff sought to enjoin a breach of the duty of care.").
737 Some commentators stated, however, the duty of care remains "vitally important in injunction and rescission cases and may well be relevant in elections, proxy contests, resignations, and removal contexts." Veasey, Finkelstein & Bigler, *supra* note 709, at 403. Similarly, the Delaware Chancery Court in *Disney* observed as follows:

Despite its eradicating effect on the duty of care, section 102(b)(7)'s democratic nature is appealing.[738] As an enabling statute, the section applies to a corporation only if shareholders approve a charter amendment to include an exculpatory provision.[739] A favorable vote of a majority of the outstanding voting shares is required for a corporation to adopt such a provision. Therefore, the section permits shareholders, to whom directors ultimately owe the fiduciary duties, to decide whether to exculpate directors from due care liability. Commentators raised concerns regarding the democratic nature of exculpatory provisions by questioning whether shareholders fully comprehend the importance of the vote on exculpatory provisions.[740] Nevertheless, shareholders' failure to make an informed decision before voting on corporate matters as residual owners should not be an excuse for imposing personal liability on directors due to a failure to make informed decisions. Moreover, the point proves too much because it denies the basic premise of corporate democracy—the efficacy of the shareholder franchise.

A charter provision authorized by section 102(b)(7) is in the nature of an affirmative defense[741] and it must be affirmatively raised by defendant directors seeking exculpation under

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> '[S]ection 102(b)(7) does not eliminate the duty of care that is properly imposed upon directors. Directors continue to be charged under Delaware law with a duty of care in the decision-making process and in their oversight responsibilities. The duty of care continues to have vitality in remedial contexts as opposed to actions for personal monetary damages against directors as individuals.'

Disney, 907 A.2d at 752 n.444 (citation omitted).

[738] *See Arnold*, 678 A.2d 541–42. The Delaware Supreme Court in *Arnold* observed as follows:

> While it is often thought to be axiomatic that a wrong must have a correlative remedy, this is not always the case. The stockholders of [the corporation] voted to enact the charter provision which now limits recovery against the directors. Thus, the absence of a remedy for monetary damages is directly attributable to the decision of the stockholders of [the corporation] to enact the charter provision authorized by 8 *Del.C.* § 102(b)(7) exempting directors from liability.

Id. (footnotes omitted); *see also* Blank, *supra* note 696, at 122 n.95, 131 (discussing democratic nature of the provision and concluding that "the amendment results in a lower standard of director responsibility that is not excused by the amendment's alleged democratic nature").

[739] Also, a majority of the original incorporators may include an exculpatory provision in the certificate of the incorporation prior to any receipt of payment for its stocks. *See* DEL. CODE ANN. tit. 8, §§ 101, 102(b)(7).

[740] *See, e.g.,* Blank, *supra* note 696, at 129–32 ("Forced to consider the liability provision as one topic in a proxy vote, shareholders will not understand the import of the vote. Corporations will encourage shareholders to approve the provisions. Shareholders, however, often will not realize that they are forfeiting a significant right.") (footnotes omitted).

[741] *Emerald Partners*, 726 A.2d at 1223; *Malpiede*, 780 A.2d at1095. *Emerald Partners* and *Malpiede* establish the rules governing the procedural posture of exculpatory provisions. The court in *Malpiede* observed as follows:

> There are several methods available to the defense to raise and argue the applicability of the bar of a Section 102(b)(7) charter provision to a due care claim. The Section 102(b)(7) bar may be raised on a Rule 12(b)(6) motion to dismiss (with or without the filing of an answer), a motion for

such a provision.[742] A failure to assert the protection under an exculpatory provision amounts to a waiver.[743] In *Malpiede*, the Delaware Supreme Court held that "any claims for money damages

> judgment on the pleadings (after filing an answer), or a motion for summary judgment (or partial summary judgment) under Rule 56 after an answer, with or without supporting affidavits.

Malpiede, 780 A.2d at 1092.The court stated, under the second option, "the charter provision could be asserted in and attached to the answer. The Court may or may not order a full or partial reply to the answer, which reply would optimally focus on the section 102(b)(7) charter provision. This would probably be the best practice to employ in these situations." *Id.* at 1092 n.56. For a detailed examination of the decisions *see* John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 114–19 (2004); 1 RADIN, *supra* note 161, at 720.

[742] *Cf.* Allen, Jacobs & Strine, *supra* note 208, at 463 ("A section 102(b)(7) defense is more properly viewed—and should be treated—as a statutory immunity rather than as an affirmative defense."). It should be noted that Delaware's affirmative defense approach with respect to section 102(b)(7) is confusing. In 1999, the Delaware Supreme Court stated that "[d]efendants seeking exculpation under such a provision will normally bear the burden of establishing each of its elements." *Emerald Partners*, 726 A.2d at 1223–24. However, in 2001, the court stated:

> Although an exculpatory charter provision is 'in the nature of an affirmative defense' under *Emerald Partners*, the board is not required to disprove claims based on alleged breaches of the duty of loyalty to gain the protection of the provision with respect to due care claims. Rather, proving the existence of a valid exculpatory provision in the corporate charter entitles directors to dismissal of any claims for money damages against them that are based solely on alleged breaches of the board's duty of care.

Malpiede, 780 A.2d at1095 n.71. Then, the court stated in *Emerald Partners*:

> The rationale of *Malpiede* constitutes judicial cognizance of a practical reality: unless there is a violation of the duty of loyalty or the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care. The effect of our holding in *Malpiede* is that, in actions against the directors of Delaware corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege well-pled facts that, if true, implicate breaches of loyalty or good faith. Otherwise, in those cases that begin with the presumption of the business judgment rule, *ab initio,* our holding in *Malpiede* establishes that the proper invocation of a Section 102(b)(7) provision can obviate a trial pursuant to the entire fairness standard, even if the presumption of the business judgment rule is successfully rebutted by a duty of care violation, since liability for duty of loyalty violations or violations of good faith are not at issue.

Emerald Partners II, 787 A.2d at 92. Although this decision provided some clarity with respect to a section 102(b)(7) provision's procedural effect, the court again muddied the water in *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006). There, the court's analysis included the "due care determinations" section even though the defendant directors were protected by a section 102(b)(7) provision. *Id.* at 52. The court did not specifically discuss whether the rebuttal of the business judgment rule on the ground of the duty of care required the defendant directors to prove the entire fairness of the transaction. Nevertheless, after *Disney*, one may argue that the court's examination of the informational element of the business judgment rule implies that directors are required to prove the entire fairness of the challenged decision where the business judgment rule is solely rebutted on the ground of the duty of care even though they are protected by an exculpatory provision. The question then arises what would happen if the directors fail to satisfy the entire fairness standard. Currently, it is not clear whether directors of a corporation with a section 102(b)(7) provision are required to satisfy the entire fairness standard where the business judgment rule is solely rebutted on the basis of duty of care. *See* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments,* 153 U. PA. L. REV. 1399, 1432–36 (2005) (discussing the "theoretical awkwardness of the 'affirmative defense' concept" with respect to section 102(b)(7) and supporting statutory immunity approach);

against directors that are based solely on alleged breaches of the board's duty of care" are dismissible once the corporation's section 102(b)(7) provision is properly invoked.[744] If, however, the shareholder complaint alleges a successful (classic) duty of loyalty (pecuniary interest) or good faith claim sufficient to rebut the business judgment rule, directors must prove the entire fairness of the transaction.[745]

b. The Ubiquitous Nature of Section 102(b)(7) Provisions

Considering potential counter-effect of exculpatory provisions on director conduct, one might think that shareholders would be reluctant to adopt such provisions, and therefore, section 102(b)(7) would not have a substantial effect on due care liability of corporate directors. Reality, however, worked exactly the opposite way. The overwhelming majority of Delaware corporations amended their certificates of incorporation to include exculpatory provisions soon after the enactment of section 102(b)(7). Therefore, exculpation practically became a default rule governing due care liability of corporate directors in Delaware.

Delaware's section 102(b)(7) was the first of the statutes that allowed exculpatory provisions in corporate charters. The State of Delaware added section 102(b)(7) to its General Corporation Law in 1986.[746] Other states quickly followed Delaware's lead and enacted similar exculpatory statutes,[747] some of which provided greater protection than section 102(b)(7).[748] Within two years, forty-one states, including those with largest corporations, had already adopted

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Lyman Johnson, *After* Enron: *Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 67–68 (2003). Johnson observed as follows:

> The [S]upreme [C]ourt clearly needs to readdress how the protection of section 102(b)(7) meshes with procedural burdens and existing standards of review. This is important because of judicial efficiency concerns and because burdens and standards of review often are outcome determinative.

Id. (footnotes omitted).

[743] Hecker, *supra* note 26, at 942.

[744] *Malpiede*, 780 A.2d at1095 n.71.

[745] *Emerald Partners,* 787 A.2d at 92.

[746] Radin, *supra* note 708, at 746.

[747] *See id.* at 747–48 (comparing and explaining statutory provisions enacted in other states); Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 381–82 (1989); Johnson, *supra* note 742, at 31 n.11.

[748] *See* Radin, *supra* note 708, at 751. For example, instead of enacting enabling statutes that permit director exculpation, Florida, Ohio, Indiana, Virginia, and Wisconsin enacted self-implementing statutes that increase the standard of culpability for director liability. *Id.* *See also* Branson, *supra* note 747, at 381 n.31 ("Indiana and Wisconsin, for example, simply abolished director liability for duty of care violations. These provisions are self-implementing: no amendment of articles of incorporation need be undertaken, although individual corporations may reinsert a duty of care in articles of incorporation or bylaws.") (citations omitted).

these statutes.[749] Today, all American jurisdictions except the District of Colombia have either charter-option or self-implementing statutes that provide directors some form of protection from personal liability for breach of the duty of care.[750]

Similarly, corporations followed a fast track to eliminate director liability for due care violations. Corporate boards have not found any difficulty in obtaining shareholders' approval to add a section 102(b)(7) provision to their certificates of incorporation, and such provisions became routine in new corporations. According to a study that examined a random sample of 180 Delaware stock companies, over ninety percent had adopted an exculpatory provision within a year of section 102(b)(7)'s enactment.[751] A more recent study showed that every Delaware corporation in a sample of one hundred "Fortune 500" companies has adopted such a provision.[752] Thus, "exculpatory provisions [virtually] became standard features in Delaware certificates of incorporation."[753] The pervasive nature of exculpatory provisions was subject to judicial comment as well. The Delaware Chancery Court in *Disney* observed that "[t]he vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by § 102(b)(7)."[754]

The number of non-Delaware corporations that adopted exculpatory provisions is very high as well. The study that examined one hundred "Fortune 500" companies showed that only two non-Delaware corporations' certificates of incorporation lacked an exculpatory provision.[755]

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[749] *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990). By the end of 1987, over thirty states had enacted liability-limiting statutes. *See also* Radin, *supra* note 708, at 747–48; Branson, *supra* note 747, at 376 (same).

[750] The formulation of statutes varies. While Delaware's charter-option provision approach is most popular, a few statutes include self-implementing liability-limiting provisions. *See* Dennis R. Honabach, Smith v. Van Gorkom: *Managerial Liability and Exculpatory Clauses—A Proposal to Fill the Gap of the Missing Officer Protection*, 45 WASHBURN L.J. 307, 313 (2006) (stating that forty-four of states have some form of charter-option statute, six states have self-implementing statutes that impose mandatory provisions limiting director liability, Utah and Louisiana have both a self-implementing liability limitation and a charter-option provisions); Bryn R. Vaaler, *2.02(B)(4) or Not 2.02(B)(4): That is the Question*, 74 LAW & CONTEMP. PROBS. 79, 82 n.19 (2011) (examining the statutes of 49 states).

[751] Romano, *supra* note 749, at 1160, 1061 n.11.

[752] Hamermesh, *supra* note 675, at 490, 497–99.

[753] Vaaler, *supra* note 750, at 82.

[754] *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 752 (Del. Ch. 2005); *see also Emerald Partners,* 787 A.2d at 90 ("the shareholders of many Delaware corporations approved charter amendments containing these exculpatory provisions"); *Malpiede,* 80 A.2d at 1095 ("[o]nce the statute was adopted, stockholders usually approved charter amendments containing these provisions").

[755] Hamermesh, *supra* note 675, at 490, 497–500. The actual number of corporations that lacked an exculpatory provision in their certificate of incorporation was six. Three of them were incorporated in states that had self-implementing liability-limiting statutes (Wisconsin, Ohio, and Florida). One corporation was incorporated in a state that did not allow exculpatory provisions at the time study was performed (Missouri). Therefore, only two

The same study examined another sample of one hundred small to mid-size companies, and among these companies only one corporation's certificate of incorporation lacked an exculpatory provision.[756] As a result of this high adoption rate, charter-option provisions mostly govern the duty of care of directors today. Therefore, directors of most corporations are freed from monetary liability for duty of care violations both in and outside Delaware. Thus, the legal process that began with a case in which the directors with impeccable credentials were found liable for an uninformed business decision concluded with practical elimination of the duty of care in the whole nation.

c. Section 102(b)(7) Exculpatory Provisions Apply to Oversight/Monitoring Cases

Judges developed the business judgment rule over years to balance the special circumstances associated with board service and directors' fiduciary liability. In that regard, the business judgment rule provided directors adequate protection from fiduciary liability. The Delaware legislature took one step forward and enacted section 102(b)(7) to allow corporations to provide directors stronger protection in the duty of care context. Where directors' action falls short the business judgment rule protection due to lack of due care, a section 102(b)(7) provision protects directors from monetary liability. Therefore, if an exculpatory provision is available, protection equivalent to the business judgment rule is applicable even directors' conduct does not qualify for the rule's protection due to a pure due care violation.

The realm of protection of exculpatory provisions is broader than the decision-making context. Section 102(b)(7) applies in the monitoring context as well. Accordingly, directors are protected from monetary liability for duty of care breaches due to their inaction or failure to monitor. Traditionally, the business judgment rule applies only if directors make a decision or judgment, and it has no role where directors abdicate their duties. In other words, the business judgment rule does not apply if directors failed to perform adequate oversight over the company. However, if an exculpatory provision is available, protection equivalent to the business judgment rule applies to director conduct which constitutes a breach of the duty of care due to inaction or oversight failure. Accordingly, a section 102(b)(7) provision extends the effect, if not literal application, of the business judgment rule to the oversight context as well.

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corporations that were incorporated in states allowing for exculpatory charter provisions lacked exculpatory provisions in their certificates of incorporation (New York and North Carolina). *Id.*

[756] *Id.* at 500–03 (ironically, it was a Delaware corporation).

d. Rationale/Policy Reason Supporting Section 102(b)(7) Provisions

The purpose of section 102(b)(7) is to attract qualified persons to serve as corporate directors and to encourage them to make risky, good faith business decisions without fear of personal liability.[757] The risk of personal liability arising from due care violations may deter many qualified persons from serving on corporate boards and cause over-cautiousness by those who do serve on boards. Section 102(b)(7) allows shareholders to avoid such potential adverse effects of due care liability by adopting exculpatory provisions.

Exculpatory provisions provide directors the freedom to pursue risky business strategies as well as the stimulus to act in good faith.[758] Shareholders include such provisions in corporate charters to assure that directors focus on business ventures and profitability rather than worrying about due care liability threating their personal wealth. At the same time shareholders are assured that their interest is protected by directors who are acting in good faith to comply with their responsibilities. The statute thus gives corporate shareholders an option to exchange their potential monetary due care claims based on corporate losses with an expectation that competent directors will make bold but good faith decisions to further their interest.

Thus, the policy behind section 102(b)(7) is "an extension of that underlying the business judgment rule."[759] Shareholders adopt exculpatory provisions to "encourag[e] capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith

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[757] *See* Prod. Res. Group, L.L.C. v. NET Group, Inc., 863 A.2d 772, 793 (Del. Ch. 2004) (stating that exculpatory provisions encourage "capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith business decisions without fear of personal liability"); *Disney,* 907 A.2d at 752(stating that purpose of section 102(b)(7) is "to encourage directors to undertake risky, hut potentially value-maximizing, business strategies, so long as they do so in good faith"); *Emerald Partners,* 787 A.2d at 90 (stating that section 102(b)(7) frees directors to take business risks without worrying about negligence lawsuits); *Malpiede,* 780 A.2d at 1095 (same); *Caremark,* 698 A.2d at 971(stating that a demanding test of liability is necessary in the oversight context, as well as in the decision making context, "since it makes board service by qualified persons more likely"); *Arnold*, 678 A.2d at 541 n.20 ("Importantly, the law, while indulging a presumption that effective remedies should be available, also considers values other than individual redress when fashioning a system of remedies."); Blank, *supra* note 696, at 120 ("By relaxing personal liability standards, the amendment provides incentive for individuals to accept again positions as directors."); E. Norman Veasey, *Economic Rationale for Judicial Decisionmaking in Corporate Law,* 53 BUS. LAW. 681, 693–94 (1998) ("[T]he investor's expectation is that it is fine to have directors who are risk-takers, unencumbered by concepts of tort liability for failure to do all their homework, an innocent failure to disclose material facts, or even a sustained inattention not rising to the level of bad faith. These investors want to attract good, honest, independent, business-like directors. They do not want timid, risk-averse people managing the firm.").

[758] *Caremark,* 698 A.2d at 971 (stating that exculpatory provisions act as "a stimulus to *good faith performance of duty* by … directors") (emphasis in original).

[759] Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities*, 54 U. KAN. L. REV. 975, 990 (2006); *see also Emerald Partners*, 787 A.2d at 91 ("The statutory enactment of Section 102(b)(7) was a logical corollary to the common law principles of the business judgment rule.").

business decisions without fear of personal liability."[760] Exculpatory provisions exonerate directors from personal liability where their decision falls short of business judgment rule protection due to grossly negligent decisional process. Furthermore, exculpatory provisions insulate directors from personal liability for due care breaches arising from oversight failures. Where a corporate charter includes an exculpatory provision, directors face no threat of personal liability for a grossly negligent action or failure to take action.

Nevertheless, some commentators were critical of the enactment of section 102(b)(7).[761] According to critiques, the enactment of section 102(b)(7) served to further the pro-management policy of Delaware.[762] Traditionally, Delaware's business friendly corporate law attracted many corporations to incorporate in that state.[763] Delaware courts generally supported this policy of state by rendering business friendly decisions.[764] The courts, however, also paid considerable attention to protect shareholder interests by establishing and developing legal standards.[765] In addition, Delaware courts have been sensitive to the public demand for director responsibility.[766] In the 1980s, an increasing public trend for greater director accountability arose.[767] Shareholders increasingly sought to hold directors liable for careless conduct through derivative litigation.[768] Accordingly, Delaware courts started to examine the fiduciary conduct of directors more closely. The *Van Gorkom* holding demonstrated that Delaware courts would not only scrutinize the fiduciary conduct of directors but would also hold them liable for a breach, regardless of the pro-corporate policy of the state. However, the Delaware Supreme Court's emphasis on fiduciary conduct at the expense of the state's pro-corporate policy was unwelcome. The holding, at the minimum, threatened Delaware's position as the dominant state for incorporation.[769] The Delaware legislature swiftly enacted section 102(b)(7) and permitted corporations to limit the types of fiduciary conduct that courts could scrutinize. Thus, the Delaware legislature limited the

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[760] *Prod. Res. Group, L.L.C.*, 863 A.2d at 793.
[761] *See, e.g.,* Blank, *supra* note 696, at 118–31 (describing the enactment of the exculpatory provision as a part of continuous effort to relax the corporate liabilities of business and management by Delaware legislature).
[762] *Id.*
[763] *See* Veasey, *supra* note 757, at 681–84 (describing the historical development of Delaware law and Delaware's dominant position as the state of incorporation).
[764] Blank, *supra* note 696, at 125.
[765] *Id* at 131.
[766] *Id.*
[767] *Id*. at 119.
[768] *Id.*
[769] *See* Honabach, *supra* note 750, at 313 n.47.

trend toward greater director accountability by preventing possible further development of due care litigation[770] and secured the state's pro-management policy.[771]

Commentators further criticized section 102(b)(7) for lowering the standard of director responsibility and limiting the courts' ability to protect shareholder interests.[772] Exculpatory provisions limit shareholders' ability to bring derivative suits which is an important mechanism to control director behavior.[773] Section 102(b)(7) primarily aimed to attract qualified to people to serve as directors, however, reduced director liability may also cause corporate boards to be filled with persons unwilling to give necessary attention to corporate matters.[774] One commentator observed on that point as follows:

> The need to attract corporate directors that are willing to accept the responsibilities of the position is a serious problem. Outside directors provide valuable independent scrutiny of corporate affairs. One desire of the drafters of the amendment is to encourage individuals to serve as outside directors. Yet if the amendment, in an effort to attract directors, relieves directors of liability for failures to perform responsibly, the amendment eliminates the benefit of an outside director because outside directors need not scrutinize diligently the affairs of the corporation. Thus, the amendment divests the role of outside director of the primary function and obligation of providing corporate oversight.[775]

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[770] Blank, *supra* note 696, at 119 (stating that the enactment of the exculpatory provision will also prevent the progress of the public desire for greater director accountability).

[771] *See* Lee, *supra* note 703, at 257; Blank, *supra* note 696, at 134 (stating that with the enactment section 102(b)(7) Delaware protects its leading position as the state of incorporation and continue to generate high income from corporate taxes and fees).

[772] Blank, *supra* note 696, at 130–31. According to the author, "the Delaware amendment is a substantial obstacle to corporate responsibility." *Id*. at 134.

[773] *Id*. at 132.

[774] *Id.* at 134.

[775] *Id*. at 133. The author argues that responsibility should be attached to directorships. The author explains this argument as follows:

> Directors should not escape liability for breaches of the duty of care resulting from gross negligence. Directors should be accountable for failures to accept the responsibility that accompanies a position on a board. Careful and dedicated directors should not enter a directorship assuming in advance the need for protection from liability for inattentiveness and lack of preparation. Supporters of the statute contend that directors generally are dedicated persons and will not take advantage of the relaxation of the standard of care. This rather naive supposition fails to recognize that if directors truly were dedicated to performing their jobs thoroughly, the insurance shortage would not have generated fear in directors. The criticism of directors does not imply that directors are unethical or opportunistic. The public, however, is demanding that boards take a more active role as overseers of the corporation. While increased responsibility will leave directors that serve on multiple boards insufficient time to satisfy all responsibilities, the demand for greater accountability suggests a need for a new role for directors. Directors should accept fewer board positions and dedicate more attention to the responsibilities accompanying the positions.

Id. at 132–33.

Thus, although there may be valid reasons behind the enactment of section 102(b)(7), critiques raised serious concern regarding the potential adverse effects of exculpatory provisions on director behavior. The real effects of exculpatory provisions on director behavior in particular, and on corporate governance in general, are yet to be discovered.

CHAPTER IV. DUTY OF LOYALTY AND GOOD FAITH

A. *Traditional Duty of Loyalty: Pecuniary Conflicts of Interest*

1. Three Periods of Common Law Development

The duty of loyalty requires directors to act honestly and loyally in their relationships with the corporation. The duty of loyalty represents the moral conduct that is essential in any legal organization: one should not abuse his or her position of trust to further self-interest at the expense of others. Directors are elected and empowered to advance the best interests of a corporation and its shareholders, and they should subordinate their self-interest (or a related person's or institution's interest) to the interest of the corporation and its shareholders when these two conflict. The duty of loyalty requires that the best interest of the corporation and its shareholders take precedence over any personal interest of a director that is not shared by the stockholders generally.[776] More than a half century ago, the Delaware Supreme Court explained the loyalty concept and the underlying public policy as follows:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[777]

Traditionally, the duty of loyalty concerns situations in which "a director … has pecuniary, self-dealing conflict of interest with the corporation."[778] A duty of loyalty issue arises where directors appear on both sides of a transaction or where they receive an exclusive personal financial benefit from a transaction that is not available to the corporation and to its shareholders generally.[779] Similarly, a director is considered to be interested "if he will be materially affected,

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[776] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
[777] Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).
[778] Hecker, *supra* note 26, at 948.
[779] *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 812 (Del.1984) ("From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."); *Cede*, 634 A.2d at 362 ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.").

either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the shareholders."[780] In a self-dealing transaction, a director's judgment is likely to be affected by his own interest. Furthermore, self-dealing transactions are isolated from market competition because they typically involve discrete and non-arms-length bargaining. In these situations, "the transaction is inherently suspect as one in which the fiduciary may be profiting at the expense of the corporation or other shareholders."[781] Therefore, where directors have an exclusive personal interest or engage in self-dealing in their fiduciary capacity, the law imposes certain requirements to assure that the interests of the corporation and its shareholders are protected.

The law governing self-dealing director transactions made a gradual progress in corporate law history. Self-dealing transactions were addressed in the common law as early as nineteenth-century.[782] In the early common law, the perception of directors' fiduciary status was heavily affected by the law of trusts.[783] Accordingly, a strict legal regime was adopted against interested director transactions. In that early period, any director self-dealing transaction was literally condemned if it was subject to a fiduciary litigation. Transactions between a corporation and one or more of its directors were absolutely voidable at the instance of the corporation or its shareholders, regardless of fairness or unfairness of the transaction.[784] A corporation or its shareholders had the litigious power to nullify an interested director transaction solely because a director appeared on both sides of the transaction.[785] Thus, under the early common law, directors' self-dealing in their fiduciary capacity was not tolerated by courts at the suit of the corporation or its shareholders.

In the course of the early twentieth century, the strict common law rule evolved into a relatively more lenient rule. Beginning circa 1910, a self-dealing transaction was not absolutely voidable; rather, it was subject to rigid procedural and substantive requirements to be upheld in a court room.[786] Within this transition period, which preceded the third and more lenient common law period, courts required two conditions to uphold a self-dealing director transaction at a

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[780] Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. 1995) (citation omitted).
[781] Hecker, *supra* note 26, at 955.
[782] *See generally* Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality,* 22 BUS. LAW. 35 (1966).
[783] *See supra* Chapter II.B.1. (discussing the historical progress of corporate fiduciary law).
[784] Marsh, *supra* note 782, at 36–39.
[785] *Id.*
[786] *Id*. at 39–40.

lawsuit; first an approval of the transaction by a disinterested majority of the board; and second, the fairness of the transaction itself.[787] As a threshold matter, the transaction had to be approved by the disinterested majority of the board. In other words, the majority of the board must have been free of conflict of interest with respect to the challenged transaction, and if so they must approve it. Only after such an approval could a self-dealing transaction be subject to judicial scrutiny under the strict fairness standard. For example, a transaction between the majority of a board and the corporation was automatically voidable at the instance of the corporation or its shareholders, without regard to its fairness or unfairness. Such a transaction was not subject to judicial fairness review because it inherently lacked the disinterested majority approval precondition. If, however, interested directors were able to obtain the approval of a disinterested majority of a board, they were then required to convince the court that the self-dealing transaction was entirely fair to the corporation and its shareholders. A transaction was not voidable solely for the reason of self-interest if directors met these two conditions.

By the middle of the twentieth- century, courts dropped "disinterested majority approval" precondition, and the common law rule evolved into the fairness rule.[788] The fairness rule of the third period is the modern common law rule governing self-dealing director transactions. Under this rule, a self-dealing transaction is subject to rigid judicial scrutiny under the entire fairness standard at the instance of the corporation or its shareholders. The burden is on interested directors to demonstrate the entire fairness of the transaction. Courts closely scrutinize all aspects of a self-dealing transaction to determine its fairness. The entire fairness standard has two basic components: fair dealing and fair price.[789] Interested directors must demonstrate that both the process and result of the self-dealing transaction are fair to the corporation. If the interested directors fail to demonstrate the entire fairness of the transaction, it will not be respected by courts. Therefore, in that period, self-interest director transactions were voidable only upon a failure of interested directors to satisfy the entire fairness standard.

The reason behind the evolution of the strict "absolutely voidable" common law rule into the "conditionally voidable" rule is the recognition that an interested director transaction may not always be detrimental to the corporation.[790] In the twentieth century, transactions between

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[787] *Id.*; 1 RADIN, *supra* note 161, at 796.
[788] Marsh, *supra* note 782, at 43–44.
[789] *See supra* Chapter III.C.4.b. (examining entire fairness).
[790] 1 RADIN, *supra* note 161, at 797 (citation omitted).

directors and corporations were increasingly subject to litigation. In reviewing those transactions, courts recognized that a self-dealing director transaction may well serve the best interest of the corporation if directors act fairly. There is a possibility that an interested director may have prioritized the corporation's interest in a self-dealing transaction. As mentioned before, a self-dealing transaction is potentially harmful to the corporation because an interested director's judgment may have been affected by her own interest adversely to the corporation's interest, and it lacks market competition due to non-arms-length bargaining. Under the fairness standard, directors are required to demonstrate that they have in fact acted in good faith in advancing the corporation's interest, and their self-interest did not adversely affect their judgment and harm the corporation. Courts closely scrutinize the fairness of an interested director transaction as an independent, neutral party. If the court finds that the transaction was entirely fair to the corporation; the directors' self-interest does not harm the corporation, and therefore, there is no reason to invalidate the transaction. Furthermore, a self- interested transaction may carry potential benefit for the corporation where the interested directors act fairly and offer the corporation more favorable terms than the market. Accordingly, a strict rule against interested director transactions may work against a corporation's best interest.[791]

One Delaware common law exception to the fairness rule is disinterested shareholder ratification.[792] If the interested director transaction is submitted to a shareholder vote, and if, after disclosure of all material facts, the majority of shareholders who are not interested in the transaction voted to approve it, the transaction is not subject to judicial review under the entire fairness standard solely because of directors' self-interest. In other words, after full disclosure, the ratification by the majority of disinterested shareholders removes the self-interest cloud from an interested director transaction. The policy underlying this exception to the fairness review of a self-dealing transaction is quite understandable. As residual owners of a corporation, shareholders are the ultimate beneficiaries to whom directors owe their fiduciary duties. Accordingly, the fairness rule is in place to protect the ultimate interest of shareholders. If the majority of disinterested shareholders, after full disclosure of all material facts, approve a self-

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[791] *See* MODEL BUS. CORP. ACT ANN. § 8 Subch. F. Intro. cmt. (2011) (explaining the potential benefits of disinterested director transactions).
[792] *See* Hecker, *supra* note 26, at 955. *Cf.* Marsh, *supra* note 782, at 48–49 (stating that, under the general common law exception, "the stock of the interested director or directors may be voted on the question of ratification, and *as shareholders* they may cast the deciding votes").

dealing transaction, there is no reason for courts to engage in a lengthy fairness process to protect the interest of the shareholders.[793] Thus, shareholder ratification negates the need for the entire fairness review of a self-dealing director transaction.

The strict common law regime governing self-dealing transactions in the nineteenth-century gradually relaxed throughout the first half of the twentieth century. In the second half, states' legislatures furthered the relaxation by adopting statutory provisions that extended the exceptions to the fairness rule. In Delaware, the statutory provision regulating self-dealing transactions was adopted in the recodification of its corporation law in 1967. The next section examines the Delaware statutory provision and its relationship with the common law rule of fairness.

2. The Fourth Period: Section 144 and "Fairness" As a Process of Review by a Fully Informed Decision-Maker

The Delaware legislature enacted section 144 when it recodified its corporation law in 1967. Section 144 provides a limited safe harbor "to prevent director conflicts of interest from voiding corporate action."[794] Generally, the section codifies the common law fairness rule and adds one more exception to judicial fairness review. Under section 144(a), an interested director transaction is not voidable on the ground of self-interest if (1) the majority of fully-informed and disinterested directors approve the transaction, or (2) fully informed (and disinterested) shareholders ratify the transaction, or (3) the interested directors demonstrate the fairness of the transaction before a court. Section 144 provides:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
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> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

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[793] *See also* Hecker, *supra* note 26, at 956 (stating that "this exception views fairness as a *process of scrutiny by disinterested, fully informed observers*, and equates scrutiny by disinterested shareholders with scrutiny by a disinterested judge") (emphasis in original); *cf.* Marsh, *supra* note 782, at 49 (criticizing the exception by stating that, when they are asked for ratification, shareholders are not able to negotiate the transaction and they are limited to rejecting or accepting the deal formulated by the interested directors).

[794] *Cede,* 634 A.2d at 365.

> (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders; or
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> (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders.
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> (b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.[795]

Under section 144(a), an interested director transaction is not subject to fairness review solely because of self-interest if, upon full disclosure of all material facts, a majority of the disinterested directors or shareholders approve the transaction. An approval either by a majority of the disinterested directors or shareholders removes the self-interest taint from the transaction and precludes judicial fairness review. In the absence of such approval, the interested transaction is subject to judicial review under the entire fairness standard, and it is not voidable only if interested directors demonstrate that the transaction is fair to the corporation. Thus, section 144(a) provides three alternative methods to shelter an interested director transaction from invalidation on the ground of self-interest.

Section 144(a)(2) recognizes the common law exception to the fairness rule: shareholder ratification. Indeed, shareholder ratification under section 144(a) is not identical to the common law exception. Section 144(a) only requires an approval by the majority of shareholders, not by the majority of *disinterested* shareholders. However, Delaware courts interpret section144(a)(2) in accordance with the common law exception to the fairness rule, and they require the shareholder vote to be disinterested under section 144(a)(2).[796] Furthermore, a recent Delaware decision added uncertainty with respect to shareholder ratification of interested director decisions.[797] In *Gantler v. Stephens,* the Delaware Supreme Court made a distinction between a shareholder vote solely for the purpose of approving an interested transaction and a shareholder vote that is statutorily required to authorize a specific corporate action or transaction.[798] This raised the question whether a statutorily required shareholder vote would also cleanse the self-

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[795] DEL. CODE. ANN. tit. 8, § 144 (2011).
[796] *See* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."); *see also* Hecker, *supra* note 26, at 958 n.189 (discussing Delaware cases interpreting section 144(a)(2)).
[797] *See* Hecker, *supra* note 26, at 959–60.
[798] 965 A.2d 695, 714 (Del. 2009).

dealing aspect of a transaction if it includes the favorable votes of the majority of disinterested shareholders. This distinction was not outcome determinative in the case, and therefore, it is not clear if Delaware courts require a distinct shareholder vote for an interested transaction which is also subject to a statutorily required shareholder vote for authorization.[799] To resolve the uncertainty created by *Gantler*, Professor Hecker suggested as follows:

> A … possible reading [of *Gantler*] that reconciles the conflict would distinguish between statutorily-required shareholder votes that coincidentally achieve approval by a majority of the voting shares held by disinterested persons (as was the case in *Gantler*) and those in which the transaction, in addition to the statutory vote, is *also specifically targeted and conditioned* on approval by a majority of the disinterested shares. In the latter case, the 'classic' ratification feature of a voluntary additional layer of independent shareholder approval would be present, albeit in the broader context of a statutorily required vote. This reading preserves the ultimate cleansing effect of long-standing doctrine, while responding to the court's concern that, to be effective, ratification must be specifically focused.[800]

Section 144(a) extends common law exception to the fairness rule by adding another category: disinterested director approval. Under section 144(a)(1), an approval by a majority of the disinterested directors cures the self-interest as long as the approving directors are fully-informed of the self-interest and all material facts, and they act in good faith to further the best interests of the corporation.[801] Such an approval protects an interested transaction from

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[799] *See id.* at 712. The court also found that the proxy statement with respect to the shareholder vote was materially misleading, and therefore, the shareholders were not fully informed. The court concluded that "the approving shareholder vote did not operate as a 'ratification' of the challenged conduct in any legally meaningful sense." *Id.* at 714.

[800] Hecker, *supra* note 26, at 960–61 (emphasis in original).

[801] *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 756 n.464 (Del. Ch. 2005). The *Disney* court observed that good faith plays an important role with respect to the director approval under section 144(a)(1). The court observed as follows:

> Under § 144(a), a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: 1) the approving directors were aware of the conflict inherent in the transaction; 2) the approving directors were aware of all facts material to the transaction; and 3) the approving directors acted in good faith. In other words, the inside transaction is valid where the independent and disinterested (loyal) directors understood that the transaction would benefit a colleague (factor 1), but they considered the transaction in light of the material facts (factor 2—due care) mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies (factor 3—good faith). On the other hand, where the evidence shows that a majority of the independent directors were aware of the conflict and all material facts, in satisfaction of factors 1 and 2 (as well as the duties of loyalty and care), but acted to reward a colleague rather than for the benefit of the shareholders, the Court will find that the directors failed to act in good faith and, thus, that the transaction is voidable.

Id. See Holland, *supra* note 10, at 687–88 ("In determining independence, the judicial inquiry goes beyond the strict type of financial ties that make a director interested. Instead, in examining challenges to a director's independence, 'Delaware courts broaden the inquiry' into the more subjective types of ties that can generate what has been called 'a sense of beholdenness.'") (footnote and citations omitted).

shareholder challenge on the ground of self-interest and therefore precludes fairness review of the transaction by courts. In other words, a good faith approval by a majority of the disinterested and informed directors substitutes for judicial fairness review.

Accordingly, under section 144, the fairness of an interested transaction is viewed as a process of review by fully informed and neutral decision-makers.[802] An approval by a majority of the fully informed disinterested directors or shareholders substitutes for strict judicial review of an interested transaction under an entire fairness standard. As the Delaware Supreme Court observed in *Oberly v. Kirby*, "[t]he key to upholding an interested transaction [under section 144(a)] is the approval of some neutral decision-making body."[803] An interested director transaction is not voidable as long as the interested party "has [not] deprived stockholders of a 'neutral decision-making body.'"[804] An independent and informed decision-making body, whether it be courts, disinterested directors, or shareholders, neutralizes the self-interest aspect of a transaction.

The business judgment rule, which is the primary standard of review in the decision-making context, presumes that directors act in good faith and make informed and disinterested decisions. Under the business judgment rule, the plaintiff carries the burden of proof to demonstrate that the defendant directors have self-interest in a transaction or that they are dominated or controlled by an interested party. If the plaintiff is able to demonstrate the existence of director self-interest or other extraneous considerations concerning a corporate decision or transaction, the burden then shifts to the defendant directors to show the approval of the transaction under section 144. If the defendant directors are unable to show such approval, the transaction is subject to strict judicial review with the burden on defendant directors to prove the fairness of the transaction. If, however, the defendant directors show that the transaction is approved under section 144(a)(1) or (2), the transaction is protected under the business judgment rule, and the burden shifts to the plaintiff to prove that the transaction constitutes corporate waste. If one considers the difficulty of proving the onerous standard of waste, plaintiffs have little chance to succeed in their claim once the transaction is protected under the business judgment rule.

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[802] *See* Hecker, *supra* note 26, at 956.
[803] 592 A.2d 445, 467 (Del. 1991).
[804] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1170 (Del. 1995).

B. The Duty to Act in Good Faith

1. Section 102(b)(7) Exculpatory Provisions Focus the Interest of Scholars and the Plaintiffs' Bar on Conduct Not in Good Faith

Section 102(b)(7) of the Delaware General Corporation Law allows a certificate of incorporation to include a provision eliminating directors' monetary liability for due care violations. Section 102(b)(7) explicitly excludes a breach of the duty of loyalty or good faith from exculpable conduct. Even if a certificate of incorporation includes an exculpatory clause, directors are liable for duty of loyalty and good faith violations. The duty of loyalty traditionally concerns self-dealing transactions. Accordingly, good faith has significant importance in defining the scope of non-exculpable conduct that does not involve director self-interest. In situations where directors are exculpated from due care liability and are free from conflict of interest, they may be held liable only if the alleged fiduciary violation amounts to the lack of good faith. Therefore, after widespread adoption of exculpatory provisions, good faith has become vitally important in determining director liability, and the focus of the plaintiffs' bar shifted from the duty of care to the duty of good faith in litigating nonpecuniary director misconduct.

The duty of good faith has long been an element of the business judgment rule, requiring directors to exercise an honest judgment seeking to advance the best interests of the corporation and its shareholders. Despite that, as one commentator observed, Delaware courts employed the concept of good faith "as something of a rhetorical grace note; it has never provided the basis for the court to decide the matter before it."[805] Accordingly, the duty of good faith was not a well-developed area of corporate fiduciary law.[806] The uncharted territory of good faith presented a fertile field for plaintiffs to re-characterize their fiduciary claims to hold directors liable for alleged director misconduct that did not involve conflict of interest. As one commentator nicely illustrated, in the post-exculpatory era good faith has become "the Achilles heel of both the business judgment rule and statutory exculpation."[807]

The implications of section 102(b)(7) in the pre-trial context of a derivative action also explain why plaintiffs moved away from litigating due care claims and focused on the duty of

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[805] Furlow, *supra* note 450, at 1063–64.
[806] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 63 (Del. 2006).
[807] Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 928 (2007).

good faith instead.[808] In *Malpiede v. Townson*, the Delaware Supreme court held that a section 102(b)(7) provision "bars a claim that is found to state only a due care violation."[809] A shareholder complaint that asserts only a duty of care claim is dismissible once the corporation's section 102(b)(7) provision is properly invoked.[810] Not surprisingly, after the *Malpiede* decision, plaintiffs have framed the fiduciary claims to state a breach of the duty of good faith in order to circumvent the exculpation of section 102(b)(7) provisions.

In the post-exculpatory era, the duty of good faith has started to receive increasingly more attention from scholars as well. The shift in the plaintiffs' bar's focus from the duty of care to the duty of good faith in litigating fiduciary misconduct raised the question to what extent could a plaintiff "transform an act or omission that violated the duty of care into a claim that would support the imposition of personal liability by showing that the careless act or omission was '"not in good faith?"'[811] Before the enactment of section 102(b)(7), the classic duties of loyalty and care provided an adequate legal framework to address director misconduct, and good faith served as an important yet spare concept under the business judgment rule. The elimination of due care liability changed this traditional picture and brought good faith to the forefront in corporate fiduciary law.

Arguably, the introduction of exculpatory provisions into the corporate law disrupted the fiduciary law doctrine that was developed by judges over a century. Under the traditional fiduciary analysis, where director conflict of interest was not at issue, a shareholder complaint alleging director misconduct would be typically litigated under the duty of care. The procedural and substantive effect of exculpatory provisions changed this traditional legal framework and created a legal gap to address egregious director misconduct which did not involve conflict of

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[808] *See* Holland, *supra* note 10, at 694.
[809] Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001). The rationale behind *Malpiede* decision is the recognition of the practical reality that, in the absence of a claim that successfully asserts a breach of loyalty or good faith, "a trial on the issue of entire fairness is unnecessary because a section 102(b)(7) provision will exculpate director defendants from paying monetary damages if the failure to demonstrate entire fairness is exclusively attributable to a violation of the duty of care." Holland, *supra* note 10, at 692.
[810] *Malpiede*, 780 A.2d at 1094; *see also Disney*, 906 A.2d at 52–53. In *Disney*, the plaintiff argued on appeal that the trial court should have first determined "whether the business judgment rule presumptions were rebutted based upon a showing that the board violated its duty of care, *i.e.,* acted with gross negligence. If gross negligence were established, the burden would shift to the directors to establish that the OEA was entirely fair. Only if the directors failed to meet that burden could the trial court then address the directors' Section 102(b)(7) exculpation defense, including the statutory exception for acts not in good faith." *Id*. The Delaware Supreme Court rejected this argument. *Id.*
[811] Furlow, *supra* note 450, at 1065.

interest yet was worse than lack of due care. Therefore, a doctrinal vehicle was needed to address this type of misconduct,[812] and the duty of good faith was a potential candidate because of its uncharted content. Moreover, the dismantlement of due care liability from fiduciary law created a discomfort among corporate scholars because the conduct that falls within the realm of the duty of care represents a fundamental aspect of board service. Although exculpatory provisions eliminate due care liability, they do not diminish the importance of the conduct expected of directors under the duty of care. Accordingly, after the elimination of due care liability, directors' good faith effort to comply with their due care responsibilities has become especially important. Scholars turned to good faith to define the contours of fiduciary obligations of directors and have extensively argued the relationship between the conduct expected of directors under the duty of care and good faith.

a. The Scope of Good Faith

The concept of good faith represents the subjective aspect of the fiduciary conduct required of directors in corporate law. Directors must act in the honest belief that they are acting in the best interests of the corporation.[813] In the corporate context, good faith requires "a true faithfulness and devotion to the interests of the corporation and its shareholders."[814] To comply with the duty of good faith, directors "must act at all times with an honesty of purpose and in the best interests and welfare of the corporation."[815] Put it another way, the honest belief and the best interests of the corporation must guide every action of corporate directors.[816] Directors are elected to further the interests of the corporation and its shareholders, and the duty of good faith ensures that they truly act for this purpose. Directors should a make a good faith effort to comply

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[812] *See Disney*, 906 A.2d at 66. The *Disney* court explained this point as follows:

> [T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.

Id.

[813] *Aronson*, 473 A.2d at 812.

[814] *Disney,* 907 A.2d at 755.

[815] *Id.*

[816] *Id.*

with their responsibilities when they act in their fiduciary capacities. Good faith "includes not simply the [classic] duties of care and loyalty, … , but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."[817] In sum, good faith requires an honest and positive subjective motivation and a genuine effort in advancing the welfare of the corporation.

The duty of good faith represents a broad concept in corporate fiduciary law, and it is very difficult to provide a complete definition that would prescribe the contours of good faith. As the Chancery Court observed in *Disney*:

> To create a definitive and categorical definition of the universe of acts that would constitute [lack of good faith] would be difficult, if not impossible. And it would misconceive how … the concept of good faith operates in our common law of corporations.[818]

Furthermore, the business judgment rule presumes that directors act in good faith.[819] The burden is on the plaintiff to demonstrate that directors' action or omission lacked good faith. In other words, a plaintiff must show by a preponderance of evidence that directors acted in bad faith.[820] Accordingly, Delaware courts explicated the scope of good faith by giving examples of bad faith conduct. If directors act with an actual intent to harm the corporation, or they knowingly violate applicable positive law, their conduct will constitute bad faith.[821] Bad faith occurs when directors intentionally act in a manner "unrelated to a pursuit of the corporation's best interests."[822] For example, directors' conduct lacks good faith if they act with a purpose other than a genuine attempt to further the interests of the corporation or if they act with a subjective motivation that is adverse to the interests of corporation. The Chancery Court in *Disney* explained that "[b]ad faith can be the result of 'any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation,' including greed, 'hatred, lust, envy, revenge, … shame or pride.'"[823] The court added that a systematic or sustained shirking of a duty may also constitute bad faith.[824]

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[817] *Id.*
[818] *Id.*
[819] *See, e.g., Aronson*, 473 A.2d at 812.
[820] *Disney,* 907 A.2d at 755.
[821] *Id.*
[822] *Id.* (citation omitted).
[823] *Id.* (citation omitted). *See also* Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless.").
[824] *Disney,* 907 A.2d at 755.

Indeed, in the real world, it is unlikely that directors would intentionally act to harm the corporation or act with a purpose other than the best interests of the corporation unless they have a pecuniary conflict of interest. The situations that involve pecuniary conflicts of interest are addressed under the classic duty of loyalty. Therefore, the practical importance of good faith is not related to pure subjective motivations of directors; rather, it is related to the discharge of directorial responsibilities.[825] In other words, the duty of good faith is especially important in situations in which an inference of bad faith may be drawn from directors' conduct, or lack thereof. For example, intentional dereliction of directorial responsibilities may implicate bad faith regardless of directors' subjective motivation. This later facet of good faith, which requires a genuine attempt to discharge directorial responsibilities, emerged after the enactment of section 102(b)(7). In the last decade, corporate scholars extensively discussed the relationship of good faith with the classic fiduciary duties of loyalty and care and questioned whether good faith was a third, independent duty. The next section briefly examines scholarly discussions concerning good faith. Afterwards, *Disney* and *Stone*, the cases in which Delaware courts addressed the relationship between good faith and the duties of care and loyalty, are examined.

b. Is It a Third, Independent Duty?

Traditionally, fiduciary obligations of directors are classified under two main duties; loyalty and care. Although good faith has long been part of directors' fiduciary duties, courts had not explicitly articulated good faith as either an independent duty or as a component of duties of loyalty or care. Under the business judgment rule, good faith served as a third, independent element. To afford the protection of the business judgment rule, directors should make (1) an informed, (2) disinterested, and (3) good faith decision. Despite being an independent element of the business judgment rule, good faith had not been conceptualized as a freestanding fiduciary duty.

In 1993, the Delaware Supreme Court in *Cede v. Technicolor* stated that, to rebut the business judgment rule, a plaintiff must prove that directors "breached any one of the triads of their fiduciary duty—good faith, loyalty or due care."[826] The court repeated the notion of good faith being part of a triad of fiduciary duties in several other decisions without specifically

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[825] *See* Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 24 (2006) ("In corporate law, as in law generally, the objective elements of good faith are far more important in practice than the subjective elements.").
[826] 634 A.2d 345, 361 (Del. 1993).

discussing whether it is a third, independent fiduciary duty.[827] It was not clear whether the court by employing a triad fiduciary analysis intended to upgrade good faith into an independent, separate fiduciary duty. Interestingly, while the Delaware Supreme Court decisions arguably signaled the emergence of an independent duty of good faith, the Delaware Chancery Court in numerous opinions conceptualized good faith as a component of the duty of loyalty.[828] Therefore, until recently, Delaware decisional law was "far from clear with respect to whether there is a separate fiduciary duty of good faith."[829]

The ambiguity concerning the status of good faith in corporate fiduciary law generated extensive scholarly commentary.[830] The doctrinal question whether good faith was an independent duty received attention with the increasing recognition of the importance of good faith after the widespread adoption of exculpatory provisions. Accordingly, the academic debate over this issue is closely tied to the content of the emerging good faith concept. Those who suggested a freestanding duty of good faith tended to assign an expansive role to the emerging concept in defining fiduciary liability of directors. [831] Others conceptualized good faith under the duty of loyalty and argued that it should play a more limited role with respect to directors' liability.[832]

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[827] *See, e.g.,* Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith."); *Malpiede* 780 A.2d at 1086 ("the board's fiduciary duties of care, good faith, and loyalty").

[828] *See, e.g.,* Nagy v. Bistricer, 770 A.2d 43, 49 n.2 (Del. Ch. 2000) ("By definition, a director cannot simultaneously act in bad faith and loyally towards the corporation and its stockholders."). In Emerald Partners v. Berlin, the Court of Chancery observed as follows:

> Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or 'subsidiary requirement' that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.

2001 Del. Ch. LEXIS 20, *86 n.63 (Del. Ch. Feb. 7, 2001); *see also* Emerald Partners v. Berlin, No. C.A. 9700, 2003 Del. Ch. LEXIS 42, *138 n.33 (Del. Ch. Apr. 28, 2003) ("Good faith is a fundamental component of the duty of loyalty, as the Supreme Court recognized in [Cede & Co. v.] Technicolor, 634 A.2d 345, 368, n.6…").

[829] *Disney,* 907 A.2d at 753.

[830] *See, e.g.,* Veasey & Di Guglielmo, *supra* note 742, at 1439–53 (discussing but not necessarily concluding whether good faith is an independent duty).

[831] *See, e.g.*, Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004); Eisenberg, *supra* note 825, at 17–18.

[832] *See, e.g.*, Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010) (arguing that the duty of good faith is a fundamental aspect of the core duty of loyalty and the duty of loyalty is not limited to self-dealing situations).

Hillary Sale, for example, focusing on court decisions at the early stage of the *Disney* case,[833] argued that the concept of good faith was moving toward a separate duty in Delaware.[834] Good faith was assuming a new role as an independent duty to address the indifference or egregiousness[835] of directors in performing their oversight or decision-making functions.[836] According to Sale, a freestanding duty of good faith was desirable because it would be "potentially more expansive, requiring fiduciary compliance in its own right and encouraging fiduciary parties to comply with their obligations."[837] Strong enforcement of an independent, separate duty of good faith would create an incentive to prompt directors to better behavior.[838] In Sale's view, a free-standing duty of good faith "creates its own incentives for fiduciaries to make thoughtful decisions *ex ante*" and deters directors from the abdication of their responsibilities.[839] In her formulation, "[a]lthough a breach of good faith need not be intentional or conscious, it does require some sort of obvious, deliberate, or egregious failure."[840] Sale argued that, although good faith may overlap other duties of loyalty and care to some extent, it should be a separate duty from loyalty and care because good faith involves "not only process or conflicts of loyalty, but also the circumstances, or lack thereof, surrounding the substantive outcome."[841]

A robust argument that the duty of good faith is a free-standing duty and an unconventional proposal with respect to its content came from learned Professor Melvin Eisenberg.[842] Examining the concept of good faith in the statutory and case law, he has argued that the domain of good faith should be distinct from the duty of loyalty and care in the corporate fiduciary context.[843] Eisenberg states that the free-standing duty of good faith "includes objective

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[833] Sale, *supra* note 831, at 471–82 (examining Brehm v. Eisner, 746 A.2d 244 (Del. 2000) and *In re* Walt Disney Co. Derivative Litig., 825, A.2d 275 (Del. Ch. 2003)).
[834] *Id*. at 471. *See also* Veasey & Guglielmo, *supra* note 742, at 1452 (stating that Sale convincingly argues that good faith is an independent, separate fiduciary duty).
[835] *See* Sale, *supra* note 831, at 488–91(proposing the application of federal scienter standards from the Rule 10b-5 for determining bad faith in cases that involve allegations based on directors' deliberate indifference); *cf.* Cristopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability,* 41 WAKE FOREST L. REV. 1131, 1180–82 (2006) (criticizing Sale's proposal for application of the scienter standard).
[836] Sale, *supra* note 831, at 484.
[837] *Id.* at 464.
[838] *Id.* at 495.
[839] *Id.* at 469.
[840] *Id*. at 493.
[841] *Id.* at 494. ("Although good faith may exist as a component of care and loyalty, confining it to those situations would diminish its power as a prophylactic tool or incentive for good fiduciary conduct.").
[842] *See generally* Eisenberg, *supra* note 825.
[843] *Id.* at 6–10.

as well as subjective elements,"[844] and "the objective elements of good faith are far more important in practice than the subjective elements."[845] The subjective element requires subjective honesty, and the objective elements include (1) an obligation not to violate generally accepted standards of business, (2) an obligation not to violate basic corporate norms, and (3) fidelity to office and faithfulness to one's duty or obligation.[846] Accordingly, Eisenberg rejects the notion that good faith is an element of the fundamental duty of loyalty and that it should be confined to subjective belief or state of mind of directors.[847] Rather, directors' subjective belief should be based on, and reviewed under, general corporate and business practices.[848] Eisenberg proposes "substantial disregard of responsibilities" as the appropriate standard for determining whether directors have acted in good faith.[849] According to Eisenberg, however, lack of good faith does not constitute a basis for liability; it rather operates as a condition.[850] Basically, substantial disregard of responsibilities constitutes a violation of both the duty of care and good faith. The violation of the duty of care provides the basis for director liability; and the violation of good faith operates to lift the liability shield of exculpatory provisions.[851]

John Reed and Matt Neiderman, on the other hand, argued that good faith, as a broad and flexible concept, served as a bridge between the duties of loyalty and care.[852] Focusing on several Chancery Court opinions,[853] they conceptualized good faith under the duty of loyalty, while recognizing that certain due care violations or other egregious misconduct would implicate the lack of good faith.[854] In their view, the disloyal conduct is not necessarily confined to self-

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[844] *Id*. at 23.
[845] *Id*. at 24.
[846] *Id.* at 24–25.
[847] *See id*. at 12–21 (criticizing Delaware Chancery Court opinions that employed the notion of good faith as being an element of the duty of loyalty).
[848] *See id.* at 23 ("[G]ood faith in law . . . is not to be measured always by a man's own standard of right, but by that which [the law] has adopted and prescribed as a standard for the observance of all men in their dealings with each other.") (quoting First Nat'l Bank of Chi. v. F.C. Trebein Co., 52 N.E. 834, 837 (Ohio 1898)).
[849] *Id*. at 62–74.
[850] *Id.* at 73.
[851] *Id*.
[852] Reed & Neiderman, *supra* note 741, at 123.
[853] *Id.* at 119–22.
[854] *Id.* at 123. The authors observed as follows:

> The 'good faith' standard, especially in the abdication context (as set forth more fully below), acts almost as a bridge between the concepts of due care and loyalty, transforming what might otherwise be deemed *certain violations of the former into violations of the latter*, even in the absence of an adverse pecuniary interest.

Id. (emphasis added).

dealing situations, and it might take many forms including bad faith conduct.[855] For example, an egregious failure to exercise an informed business judgment or reckless indifference to the substance of a material corporate action would constitute bad faith conduct, and therefore, it would implicate disloyalty. Accordingly, they argued that the duty of loyalty is broader than classic financial self-interest context and categorized good faith as a component of this broader loyalty concept.

Likewise, Chancellor (now Chief Justice) Strine, with three other colleagues, argued that good faith is not a separate, free-standing fiduciary duty; rather, it is a "fundamental aspect of the core duty of loyalty."[856] They stated that "the basic definition of the duty of loyalty is the obligation to act in *good faith* to advance the best interests of the corporation," and the duty of loyalty is much broader than the financial conflict of interest context.[857] According to the authors, good faith in corporate fiduciary law represents the state of mind with which directors must act to comply with the duty of loyalty.[858] They criticized advocates of an independent duty of good faith for attempting to convert grossly negligent conduct to bad faith conduct and diminishing the liability protection permitted under section 102(b)(7).[859] They explicitly rejected the view that the duty of good faith includes objective elements or that some objective criteria should play a role for determining bad faith conduct.[860] In their view, directors may only be held

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[855] *Id*.
[856] *See* Strine et al., *supra* note 832, at 640–73 (employing a historical, etymological, and policy-oriented analysis in discussing that good faith is an element of the duty of loyalty).
[857] *Id.* at 629 (emphasis added).
[858] *Id.*
[859] *Id.* at 696. The authors stated as follows:

> There are plausible arguments that can be made that well-paid independent directors hired mostly to be monitors ought to be subject to liability if they commit an act of gross negligence. Rather than push that argument directly, though, some advocates had used the *Technicolor-inspired* notion of a free-standing duty of good faith to pursue that argument in a less-than-overt way, by infusing the new duty with the spirit of *Van Gorkom* and pushing it away from a more rigorous standard dependent on a showing that the director acted in subjective bad faith. *Stone v. Ritter* made plain that opponents of section 102(b)(7) provisions had to make their case in forums other than courts by pushing boards to amend charters to repeal exculpatory provisions or pushing the Delaware General Assembly to repeal section 102(b)(7). That is, these advocates had to make the straightforward argument that the duty of care ought to be enforceable through a damages award and prevail on that argument at the ballot box or in the legislature.

Id. (emphasis in original). *See also* Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 574 (2008) (criticizing proponents of a free-standing fiduciary duty of good faith).
[860] Strine et al., *supra* note 832, at 632. According to the authors, this argument undermines the protection of exculpatory provisions:

liable if a court finds that a particular director acted with subjective bad faith by consciously failing to make a good faith effort to comply with directorial responsibilities.[861]

Thus, the increasing recognition of the importance of good faith in the post-exculpatory era triggered the academic debate regarding its status and role in defining directors' liability in the non-self-dealing context. The key question in this debate is whether courts should employ a subjective or objective standard in reviewing directors' good faith. The Delaware Supreme Court addressed this question and the status of good faith in *In re Walt Disney Co. Derivative Litig.*[862] and *Stone v. Ritter*.[863] In *Disney*, the Delaware Supreme Court explicated the concept of good faith and its interaction with the duty of care. Soon after, in *Stone* the court resolved the doctrinal question concerning whether good faith was a separate, independent fiduciary duty. The next sections examine the duty of good faith in *Disney* and *Stone*.

2. *Disney* and *Stone*

a. *Disney*

The duty of good faith and a board's decision-making process (the duty of care) played an eminent role in *In re Walt Disney Co. Derivative Litigation*.[864] In that case, several

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> In particular, advocates and scholars who opposed the passage of section 102(b)(7) saw room to argue that a director could be held liable, not because a fact-finder ultimately found her to have acted in subjective bad faith, but because she had fallen below some 'objective' standard of good faith. In other words, the kind of objectivity that is reflected in tort law's requirement that a person act in the manner that a reasonable person would in the same or similar circumstances would be poured into the free-standing duty of good faith, and directors would be held liable if they fell short of this objective standard.

Id. (footnotes omitted).

[861] *Id.* at 629–30.

[862] 906 A.2d 27, 34 (Del. 2006).

[863] 911 A.2d 362 (Del.2006).

[864] 825 A.2d 275 (Del. Ch. 2003). The procedural history of the case is as follows: Several shareholders of the Walt Disney Company brought a derivative complaint against its directors without making a pre-suit demand on the board. *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 353 (Del. Ch. 1998) [hereinafter *Disney I*]. The complaint alleged, *inter alia*, that the defendant directors breached their fiduciary duties with respect to the hiring of Michael Ovitz as the president of the company and his subsequent termination with a large severance package after a brief tenure. The key element in the complaint was that directors failed to compute the potential cost of the large severance package resulting from no-fault termination, and they approved it without being aware of its magnitude. The defendants moved to dismiss the complaint, arguing that it failed to comply with Court of Chancery Rule 23.1, which requires plaintiffs either to make a demand on the board or to plead particularized facts that excuse such demand. *Id.* The Chancery Court concluded that the complaint failed the *Aronson* demand excuse test because it did not create a reasonable doubt with respect to the directors' independence or absence of self-interest and the applicability of the business judgment rule. *Id.* at 361, 365. The Chancery Court observed: "It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.' Because the Board's reliance on [the expert] and his decision not to fully calculate the amount of

shareholders of the Walt Disney Company brought derivative actions against the directors of the company.[865] The plaintiff shareholders alleged that the board's compensation committee and the full board breached their respective fiduciary duties in the decisional process concerning the employment and subsequent no-fault termination of Michael Ovitz as the president of the company.[866] The employment contract of Ovitz included a non-fault termination provision with a large severance package. After fourteen months of Ovitz's unsuccessful service as the president of the company, his employment was terminated without cause, and he was granted a large severance package: approximately $130 million in cash and stock options.[867] The complaint included factual allegations asserting that the directors' decision-making process regarding Ovitz's employment and termination involved egregious failures, and, therefore, they failed to discover the potential large severance package under the non-fault termination provision of the agreement.[868] The Court of Chancery denied a motion to dismiss after concluding that the facts alleged in the complaint, if true, suggested that the defendant directors "failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties,"[869] and that they "*knew* that they were making material decisions without adequate informa*tion* and

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severance lack 'egregiousness,' this is not that rare case. I think it a correct statement of law that the duty of care is still fulfilled even if a Board does not know the exact amount of a severance payout but nonetheless is fully informed about the manner in which such a payout would be calculated. A board is not required to be informed of every fact, but rather is required to be reasonably informed. Here the Plaintiffs have failed to plead facts giving rise to a reasonable doubt that the Board, as a matter of law, was reasonably informed on this issue." *Id.* at 362. Accordingly, the Chancery Court dismissed the complaint for failure to make a demand on Disney board. *Id.* at 380. The Delaware Supreme Court refused to take such a deferential position and reversed the Chancery Court's dismissal of fiduciary duty and waste claims to the extent that it was with prejudice, affording the plaintiffs "a reasonable opportunity to file a further amended complaint" on remand to the Chancery Court. Brehm v. Eisner, 746 A.2d 244, 248 (Del. 2000) [hereinafter *Disney II*].The Delaware Supreme Court observed: "This is potentially a very troubling case on the merits. On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory." *Id.* at 249. The plaintiffs filed an amended complaint, and the Chancery Court concluded that the new complaint sufficiently pleaded a breach fiduciary duty to withstand a motion to dismiss under Chancery Rules 23.1 and 12(b)(6) and allowed the plaintiffs to proceed to discovery on the merits of their claims. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 291 (Del. Ch. 2003) [hereinafter *Disney III*]. At the trial, the Chancery Court concluded that the defendant directors did not breach their fiduciary duties or commit waste and entered judgment in favor of the defendants as to all claims in the complaint. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 779 (Del. Ch. 2005) [hereinafter *Disney IV*]. The Delaware Supreme Court affirmed. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 75 (Del. 2006) [hereinafter *Disney V*].

[865] *Disney III,* 825 A.2d at 277–78.

[866] *Id.*

[867] *Disney V*, 906 A.2d at 34.

[868] *Disney III*, 825 A.2d at 278.

[869] *Id.* at 278.

without adequate deliberation."[870] Allegedly, directors "did not care if the decisions caused the corporation and its stockholders to suffer injury or loss,"[871] and they "*consciously and intentionally disregarded their responsibilities.*"[872]

At its heart, *Disney* is a duty of care case because it primarily relates to directors' (allegedly) deficient decision-making process. Directors' self-dealing or subjective motivation did not play a major role in the case. However, the plaintiffs characterized their claims so as to state a breach of the duty of good faith because the certificate of incorporation of Disney included a section 102(b)(7) provision.[873] Section 102(b)(7) enables corporations to exculpate directors from monetary liability for due care breaches, but it explicitly excludes "actions or omissions not in good faith" from exculpable conduct.[874] Although a board's decision-making process traditionally falls within the realm of the duty of care, the plaintiffs, in order to circumvent the exculpation provision barrier, alleged that directors did not act in good faith in approving the employment contract of Ovitz.[875] In other words, "the plaintiffs contended that gross negligence (care) was on a continuum and that at some point, a board's lack of care could become so egregious that it constituted bad faith."[876] The exceptionally generous severance package afforded to Ovitz under the non-fault provision of the employment contract, and the casual decision-making process of the defendant directors provided a fertile ground for the plaintiffs to characterize their claims under the duty of good faith. The plaintiffs argued that the defendant directors should be held personally liable because their decisional process implicated "a knowing or intentional lack of due care,"[877] therefore, a breach of the duty of good faith. According to the complaint, the defendant "directors abdicated all responsibility to consider appropriately an action of material importance to the corporation."[878] That allegation gave rise to the question "whether the board's decision-making processes were employed in a good faith

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[870] *Id*. at 289 (emphasis in original).
[871] *Id.*
[872] *Id.* (emphasis in original).
[873] *Id*. at 286.
[874] *See supra* Chapter III.E.2.a.
[875] *See*, *e.g*., Strine et. al., *supra* note 839, at 688, 692. *See also* Furlow, *supra* note 450, at 1075 (observing that the *Disney* "plaintiffs sought to extend *Caremark*'s abdication-of-duty theory from the oversight context to the decisionmaking context").
[876] Holland, *supra* note 10, at 695.
[877] *Disney III*, 825 A.2d at 278.
[878] *Id.*

effort to advance corporate interests."[879] In sum, the plaintiffs conflated due care and good faith claims and alleged that directors acted in bad faith by making a material decision without either adequate information or deliberation. After concluding that the complaint raised doubt concerning the applicability of the business judgment protection, the Chancery Court denied the defendant directors' motion to dismiss.[880]

At the trial, the Court of Chancery concluded that, while being far from the best practices of ideal corporate governance,[881] the defendant directors' decision-making process did not constitute a breach of the duty of care.[882] The court found that, despite the irregularities in the decisional process, the board's compensation committee acted on an informed basis in approving the employment contract and the no-fault termination provision.[883] The court's factual analysis indicated that, the members of the compensation committee held a meeting to decide Ovitz' employment and compensation, they had prior knowledge of the agenda of the meeting, they were provided a term sheet that explained key terms of Ovitz's employment contract, and they made their decision upon reasonably relying on the expert opinion.[884] Although the members of

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[879] *Id.*
[880] *Id.*
[881] *Disney IV,* 907 A.2d at 697.
[882] *Id*. at 760.
[883] *See id.* at 760–71.
[884] *See id.* The Court of Chancery employed the *Van Gorkom* analysis to determine whether the defendant directors' decisional process was grossly negligent. It is arguable, however, whether the Disney directors' decisional process should have passed muster under the *Van Gorkom* analysis. First, although the compensation committee was informed about the agenda of the meeting, Ovitz's employment was decided and announced by the management prior to the meeting. *Id*. at 798. Second, the meeting lasted only one hour and included the discussion of other issues. *Id.* It is questionable whether the directors spent sufficient time in reviewing the term sheet and discussing the issue. The decisional process in *Disney* was arguably perfunctory and it was far from providing directors a meaningful opportunity to deliberate on the issue. In *Disney*, Delaware courts arguably relaxed judicial scrutiny of a decisional process under gross negligence in favor of directors. For example, in *Disney*, the Chancery Court noted that, although the directors had failed to compute the actual numbers concerning the severance package, they were aware of its magnitude. Similarly, the Delaware Supreme Court's analysis implied that the defendant directors would have reached the same decision had they followed "a 'best practices' scenario." *Disney V*, 906 A.2d at 56 (comparing the defendant directors' decisional process with a best case scenario). Accordingly, the *Disney* courts considered the subjective elements of the case in determining whether the directors were grossly negligent with respect to the decisional process. In other words, the *Disney* courts did not employ a strict objective test with an exclusive focus on the decisional process. In contrast, the *Van Gorkom* court's exclusive focus under the gross negligence analysis was the challenged decisional process, and the court did not consider the subjective elements of the case (e.g. the directors' familiarity with the financial status of the corporation). *See supra* Chapter III.E.1.a. (examining *Van Gorkom* and scholarly criticism). *See also* Balotti & Hanks, *supra* note 378, at 1344. The authors observed with respect to *Van Gorkom* as follows:

> Thus, failure to gather and weigh sufficient information and acting with undue haste has resulted in personal liability for directors. *This is true even though the same decision might have been, or likely would have been, reached if an adequate process had been followed.*

the compensation committee had not actually computed the numbers concerning the non-fault severance package, they were aware of the magnitude of it because they knew that Ovitz's compensation arrangements were comparable to other executives of the company, and they were highly familiar with the other executives' compensation arrangements. Accordingly, they approved Ovitz' employment contract while being aware of the large severance package, and that it was necessary to convince Ovitz to give up his lucrative position and earnings in his privately owned business. Ovitz had a reputation, experience and skills in the entertainment industry, and he was potentially valuable to Disney. The employment agreement and the non-fault termination provision were designed and approved upon the consideration of these factors, and they were not simply a result of directors' ignorance or faulty decision-making process. Accordingly, the members of compensation committee were informed of all material information reasonably available to them, and, despite its unfortunate consequences, their decision to approve Ovitz's employment contract was a product of sound business judgment.[885]

The court then determined that, under the bylaws of Disney, it was the board's compensation committee's responsibility to establish and approve Ovitz's compensation arrangements, and the full board was only responsible to elect (or reject) Ovitz as the president of the company.[886] The court found that the full board was informed of key elements of the employment contract, and it had reasonably relied on the compensation committee's decision concerning the employment and compensation of Ovitz when it appointed him as the president of the company.[887] The court held that the defendant directors (the full board and the compensation committee) did not act in a grossly negligent manner in their decisional process, and, therefore, they did not breach their duty of care.[888] Thus, the plaintiffs failed to rebut the business judgment rule presumption on the ground of the duty of care.

Id. (footnote omitted) (emphasis added). Therefore, in *Disney*, Delaware courts employed a more flexible approach by expanding the gross negligence test to include the subjective factors.

[885] *Disney IV,* 907 A.2d at 760. *See also* Claire A. Hill & Brett H. McDonnell, Disney*, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 846–48 (2007) (criticizing the Chancery Court's approach in analyzing the facts of the case).

[886] *Disney IV,* 907 A.2d at 771–72.

[887] *Id.*

[888] *Id.* at 772. The court also held that the compensation arrangements of Ovitz, including the non-fault severance package, did not constitute waste because the employment contract was not "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Id.* at 759. The court also stated that the non-fault termination of Ovitz did not constitute waste because he could not be terminated for cause given his performance as the president of the company. *Id.*

The plaintiffs also failed to rebut the business judgment rule on the ground of lack of good faith.[889] The Court of Chancery began its analysis by explaining the concept of good faith[890] and providing examples of bad faith conduct. The court stated:

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or *where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.* There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.[891]

Among these examples, the bad faith conduct arising from "intentional dereliction of a duty, a conscious disregard for one's responsibilities"[892] captured the good faith claims in the case. The Chancery Court provided this definition as "*an* appropriate *(although not the only)* standard for determining whether fiduciaries have acted in good faith."[893] Under this definition, it was hardly surprising that the court found no bad faith in directors' decisional process. The defendant directors' due care compliance a *fortiori* eliminated the possibility of conscious disregard or intentional dereliction of their procedural responsibilities. The court further found that, despite the high cost of Ovitz to the company, the directors believed that his employment was in the best interests of the corporation.[894] The court held that directors acted in good faith and their decisional process did not represent an intentional dereliction or conscious disregard of their fiduciary responsibilities.

On appeal, the plaintiffs contended that the trial court's definition of bad faith as "intentional dereliction of a duty, a conscious disregard of one's responsibilities" was substantively wrong.[895] According to the plaintiffs, "directors violate their duty of good faith if they are making material decisions without adequate information and without adequate deliberation."[896] The Delaware Supreme Court rejected this argument and held that "a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (gross negligence)."[897] The

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[889] *See id.* at 760–71.
[890] *See infra* Part B.1.a. (examining the scope of good faith).
[891] *Disney IV,* 907 A.2d at 755 (emphasis added).
[892] *Id.*
[893] *Id.* (emphasis added).
[894] *Id.* at 772.
[895] *Disney V*, 906 A.2d at 62.
[896] *Id.*
[897] Holland, *supra* note 10, at 695.

Supreme Court stated that this claim was simply a "verbal effort to collapse the duty to act in good faith into the duty to act with due care."[898] In other words, the plaintiffs asked the Supreme Court to "treat a failure to exercise due care as a failure to act in good faith."[899] The Supreme Court rejected this argument and upheld the Chancery Court's definition of bad faith conduct as a legally appropriate (although not exclusive) standard.[900] Indeed, even the plaintiffs' own definition of bad faith would not help their case because they failed to establish a breach of the duty of care at the trial. The Supreme Court affirmed the trial court's holding that directors did not breach their duty of care, and that they did not act in bad faith concerning the employment and termination of Ovitz.[901]

The Supreme Court provided further explication concerning the duty of good faith. The court observed that at least three different categories of fiduciary misconduct might fall within the realm of bad faith.[902] The first category, at one end of the spectrum, is subjective bad faith.[903] Subjective bad faith is the fiduciary misconduct that involves an actual intent to do harm to the corporation or other improper intent (e.g., preferring extraneous considerations over the corporation's interest), and it constitutes obvious, quintessential bad faith conduct.

The second category of misconduct, which is at the opposite end of the spectrum, involves grossly negligent conduct (lack of due care) without any malevolent intent.[904] The court explicitly held that the lack of due care—a failure to be informed of all material information by a grossly negligent process—, without more, cannot constitute bad faith.[905] In so holding, the court nullified the plaintiffs' attempt to circumvent the exculpatory provision by equating grossly negligent process with bad faith conduct. The court stated that equating grossly negligent conduct with "acts or omissions not in good faith" would eviscerate the protection afforded to directors under section 102(b)(7).[906] The court emphasized that from a legal standpoint, directors' duties of care and good faith must remain distinct. The court observed as follows:

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[898] *Disney V*, 906 A.2d at 63.
[899] *Id.*
[900] *Id.* at 67.
[901] *Id.* at 75. The Supreme Court also approved the Chancery Court's holding that the employment contract and the non-fault termination that granted Ovitz large severance package did not constitute waste. *Id.* at 75.
[902] *Id.* at 64.
[903] *Id.*
[904] *Id.*
[905] *Id.* at 65.
[906] *Id.*

> From a broad philosophical standpoint, that question is more complex than would appear, if only because … 'issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty....' But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct.[907]

The court then addressed the third category of fiduciary misconduct, which fell between the categories of subjective bad motivation and grossly negligent conduct.[908] This intermediate category is what the Court of Chancery intended to capture with the bad faith definition of "intentional dereliction of a duty, a conscious disregard for one's responsibilities."[909] The Supreme Court explicitly held that this category of fiduciary misconduct constitutes a violation of the duty of good faith, and it is not exculpable under section 102(b)(7).[910] The court explained why this category constitutes bad faith as follows:

> [T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (*i.e.,* preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.[911]

Thus, an intentional or conscious violation of the duty of care constitutes bad faith. Egregious process failures that implicate more than grossly negligent conduct may amount to the lack of good faith. If directors *know* that they make a material decision without adequate

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[907] *Id.*
[908] *Id.* at 66.
[909] The Supreme Court stated that this intermediate category was also recognized in section 102(b)(7). The Supreme Court observed as follows:

> [T]he legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the DGCL expressly denies money damage exculpation for 'acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.' By its very terms that provision distinguishes between 'intentional misconduct' and a 'knowing violation of law' (both examples of subjective bad faith) on the one hand, and 'acts...not in good faith,' on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for 'acts...not in good faith' must encompass the intermediate category of misconduct captured by the Chancellor's definition of bad faith.

Id. at 67. *See* Bishop, *supra* note 807, at 933 (criticizing the court for relying on the formulation of the exculpatory statute provision by stating that the statute was predicated on common law in the first place); Bruner, *supra* note 835, at 1150 (criticizing the formulation of the exculpatory language and the court's reliance on it).
[910] *Disney V,* 906 A.2d at 67.
[911] *Id.*

information, or if they deliberately fail to make *any* good faith attempt to exercise an informed business judgment, their conduct may constitute a breach of the duty of good faith. If directors' conduct demonstrates that they were "consciously indifferent to a material issue facing the corporation,"[912] or if their action or inaction was a result of "reckless indifference to or a deliberate disregard of the [corporation's] interests"[913] they may be held personally liable regardless of exculpatory protection. In the decision-making context, it is the egregiousness or magnitude of due care violation that may infer bad faith conduct. In the oversight context, it is the ongoing nature of the violation—a sustained and systematic failure—that may constitute bad faith.[914] And the necessary condition in either context for bad faith liability is the subjective element: directors' "consciousness" or "awareness" of their failure in complying with their responsibilities.

The *Disney* case involved the directors' decision-making process and the explication of conduct not in good faith. Shortly after *Disney*, the Supreme Court applied the good faith standard in the oversight context in *Stone v. Ritter*.[915] The *Stone* court also resolved the doctrinal issue concerning whether good faith is an independent, separate fiduciary duty. The next section examines the good faith analysis of the Supreme Court in *Stone*.

b. *Stone v. Ritter*

In *Stone*, the plaintiff shareholders claimed director liability for failing to discharge their responsibilities in overseeing the corporate executives' and other employees' compliance with the federal money-laundering laws.[916] The standard for determining director liability in the oversight context had been previously articulated by the Court of Chancery in *In re Caremark International Inc. Derivative Litigation* as follows:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation … in my opinion only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability.[917]

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[912] *Disney III,* 825 A.2d at 291.
[913] *Disney V*, 906 A.2d at 67 n.111.
[914] *See* Reed & Neiderman, *supra* note 741, at 123 ("It is the magnitude or ongoing nature of the action(s) or inaction(s) that provides the indicia of what ultimately needs to be proven—i.e., the director's good faith or bad faith motivation ("state of mind").
[915] 911 A.2d 362 (Del. 2006).
[916] *Id*. at 364.
[917] 698 A.2d 959, 971 (Del. Ch. 1996). *See generally* Hillary A. Sale, *Good Faith's Procedure and Substance, In re* Caremark International Inc., Derivative Litigation*,* UNIVERSITY OF IOWA LEGAL STUDIES RESEARCH PAPER 8-20

The Supreme Court held that the *Caremark* standard articulated the necessary preconditions for director liability for lack of good faith in the oversight context.[918] The court stated that the *Caremark* standard described bad faith conduct in the oversight context and that it was fully consistent with one of the examples of bad faith conduct provided in *Disney*: "intentional failure to act in the face of a known duty to act, a conscious disregard of a duty."[919] The Supreme Court further explained the necessary conditions for good faith liability in the oversight context as follows:

> (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.[920]

The court added that "[i]n either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."[921]

05/2008, at 1 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133570. Sale points out the importance of the *Caremark* decision in shifting the focus "from exculpable care claims to non-exculpable good-faith claims." *Id.* Exculpatory provisions precluded shareholder complaints that did not involve traditional duty of loyalty violation because complaints with claims for damages grounded solely on duty of care violations were subject to dismissal. *Caremark* provided that certain oversight failures are not covered by exculpatory provisions and actionable under good faith. Accordingly, *Caremark* created room for plaintiffs to plead good faith allegations in their claims. Over time, "as the pleading process changed and cases survived the motion to dismiss [e.g. *Disney* litigation], good faith evolved from a procedural pleading mechanism to a defined, substantive directorial obligation." *Id*. at 2. *Cf.* Bainbridge et al., *supra* note 859, at 595–97 (stating that, under *Caremark,* oversight liability was articulated as a species of the duty of care, and criticizing the approach that categorizes *Caremark* oversight liability under good faith for moving oversight breaches from exculpable due care conduct to non-exculpable bad faith conduct and thereby expanding the scope of director liability).

918 *Stone,* 911 A.2d at 370.

919 *Id.* at 369.

920 *Id.* at 370 (emphasis added).

921 *Id. See also* Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007) (stating that, to hold directors liable for a failure in monitoring under *Caremark*, "the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care"). It should be noted that directors' "knowing" that they were not discharging their responsibilities was not a necessary condition for good faith liability in *Caremark*. The Caremark court stated: "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability." *Caremark*, 698 A.2d at 971. The *Stone* court endorsed the *Caremark* standard and added a "knowing" element as a necessary condition for liability. Accordingly, *Stone* clearly increased the liability bar under the *Caremark* standard. *See* Bainbridge et al., *supra* note 859, at 598–604. (stating that the subjective state of mind of directors was not an element of the *Caremark* standard and that *Stone* court created a set ambiguities with respect to oversight liability by radically reinterpreting *Caremark*). "[B]y requiring 'a showing that the directors knew that they were not discharging their fiduciary obligations,' the *Stone* court arguably disallows director liability in the paradigm case in which a board over a sustained period of time simply failed to even consider whether a law compliance program was necessary." *Id*. at 605 (citation omitted). *See also* Bainbridge, *supra* note 311 at 975–78 (stating that the *Stone* court in fact endorsed the *Guttman* interpretation of *Caremark*, which '"transformed director oversight liability from a duty of care claim into a duty of loyalty claim"') (citation omitted).

The key holding of *Stone* is that it resolved the issue left open in *Disney*[922] concerning the status of good faith. *Stone* held that good faith is not a separate, independent fiduciary duty; it is rather a subsidiary element of the fundamental duty of loyalty.[923] The Supreme Court stated that director conduct that is not in good faith also constitutes disloyal conduct, and it results in liability because it constitutes a breach of the duty of loyalty.[924] The Supreme Court adopted the rationale found in opinions of the Court of Chancery explaining why good faith is a subsidiary element of the duty of loyalty: "A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."[925] The Supreme Court concluded as follows:

> [T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.[926]

Thus, the duty of loyalty has expanded from its classical financial conflict of interest constraints to include non-pecuniary misconduct that lacks good faith. The *Stone* court observed: "[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith."[927] The court stated that "good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty," but in the legal context it is a part of

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[922] *Disney V*, 906 A.2d at 67 n.112.
[923] *Stone,* A.2d at 370. *See also* Bainbridge et al., *supra* note 859, at 585–86 (criticizing *Stone* for subsuming good faith into the duty of loyalty and raising concerns with respect to inapplicability of the entire fairness standard in the good faith context). The authors criticized *Stone* for subsuming good faith into the duty of loyalty as follows:

> Liability for acts in bad faith thus will look a lot more like that imposed in cases involving a breach of the duty of care than the duty of loyalty. If someone 'intentionally acts with a purpose other than that of advancing the best interests of the corporation,' for example, it makes no sense to ask whether the action was fair to the corporation. Instead, the relevant question is whether the corporation was harmed and, if so, by what amount.
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> Good faith thus raises the issue of causation in a way that traditional loyalty concerns do not. After all, if the plaintiffs are setting out to recover the amount by which the defendant harmed the corporation, presumably they need to show that the defendant's conduct in fact harmed the corporation. Indeed, it would be unfair to impose liability without a showing of causation.

Id. (footnotes omitted).
[924] *Stone,* A.2d at 370.
[925] *Id.* (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del.Ch.2003)).
[926] *Id.*
[927] *Id.*

the duty of loyalty.[928] Thus, while maintaining recognition of the new, emerging concept of good faith, the Supreme Court held that it is a component of the duty of loyalty.[929]

3. "Conscious Disregard of One's Responsibilities": A Meaningful Standard or a Rhetorical Device?

In the post-exculpatory world, good faith plays an eminent role in defining the contours of directors' fiduciary obligations. Traditionally, the duty of good faith was defined to require an honest exercise of business judgment seeking to advance the best interests of the corporation. More recently, good faith assumed an additional role in corporate fiduciary law: a positive duty of devotion to directorial responsibilities. Directors must make a genuine, good faith effort to comply with their fiduciary duties when discharging their responsibilities. The Delaware Supreme Court explicated the emergent concept of good faith in the decision-making context in *Disney* and introduced a new standard for reviewing alleged director misconduct in non-self-dealing cases: "intentional dereliction of duty, a conscious disregard for one's responsibilities."[930] In *Stone*, the court explicated this standard in the oversight context and subsumed good faith into the duty of loyalty.[931]

The emergent concept of good faith and the corresponding standard generated an extensive scholarly commentary. While some commentators praised Delaware's new good faith doctrine,[932] others raised concerns with respect to its adequacy in addressing director inattentiveness.[933] Delaware courts set the liability bar under the new good faith standard quite

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928 *Id.* The Delaware Supreme Court thus recast its former triad formulation of fiduciary duties as a mere colloquialism.
929 *See* Bainbridge et al., *supra* note 859, at 584 (stating that the *Stone* holding appears to be "a compromise between those scholars and jurists who wanted to elevate good faith to being part of a triad of fiduciary duties and those who did not, with the former losing as a matter of form, and the latter losing as a matter of substance").
930 *Disney V*, 906 A.2d at 66.
931 *Stone*, 911 A.2d at 370.
932 *See, e.g.,* Strine et. al., *supra* note 839, at 688–91, 695–96 (praising *Stone*'s infusion of good faith into the duty of loyalty and its clarification that the main focus of judicial inquiry under good faith is a particular director's subjective state of mind); Bishop, *supra* note 807, at 939 (stating that the most significant result of the new good faith doctrine is "indoctrination of social norms of loyalty into Delaware corporate governance").
933 *See, e.g.*, Hill & McDonnell, *supra* note 885, at 833. The authors argue that the Delaware Supreme Court squandered an opportunity to develop and articulate an appropriate doctrinal approach under good faith for the situations that involve structural bias such as executive compensation. *Id.* They do not present a categorical definition of the situations that involve structural bias, they rather state that the courts should identify these situations while retaining flexibility. *Id.* at 858. They propose that "[p]laintiffs should be allowed to demonstrate bad faith with a two-part showing: (1) the challenged decision occurred within an environment of structural bias [e.g., executive compensation], and (2) influenced by that structural bias, the directors were grossly negligent in making the challenged decision." *Id.* at 833.The authors also criticizes the Delaware Supreme Court for equating "bad faith" with "absence of good faith." In their view, "bad faith" and "absence of good faith" should be treated as two distinct

high. Only a very extreme and unlikely set of facts would result in personal liability for acting in bad faith. It is questionable if the new good faith standard is practically applicable for reviewing inattentive director conduct which does not involve a pecuniary conflict of interest or waste. In the real world, it is hard to imagine that, in the absence of a pecuniary conflict of interest or any other ill-intent, directors would deliberately act solely with a purpose to abdicate their responsibilities. As one commentator observed:

> It follows that the only way a board is going to be held liable for breach of fiduciary duty when it isn't self-dealing is to (1) really not have any idea what it is doing; and (2) not have a 102(b)(7) clause in the charter; or (3) have such a clause but proceed in conscious disregard of the board's responsibility, which would be truly puzzling in the absence of self-dealing. In other words, the board will be liable for non-self-dealing conduct on a cold day in August in Miami under a blue moon.[934]

In *Disney*, the Delaware Supreme Court made it clear that bad faith requires worse dereliction than grossly negligent conduct. While this holding is inevitable to uphold the protection afforded directors by section 102(b)(7), it is very difficult for a plaintiff to demonstrate bad faith conduct unless directors commit fraud or waste. Gross negligence already requires an extreme deficiency in performance of directorial responsibilities. In order to prove grossly negligent conduct, a plaintiff should demonstrate "facts that suggest a *wide* disparity between the process the directors used ... and that which would have been rational."[935]

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concepts. While bad faith involves a problematic intention (e.g. intentional dereliction of duty), "absence of good faith" is the conduct that lacks "genuine care" but does not involve any problematic intention or state of mind. The authors suggest that courts should use "absence of good faith" standard in the context of structural bias. *Id*. at 857; Anne Tucker Knees, *Who's the Boss? Unmasking Oversight Liability within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199 (2010). The author criticizes the Delaware Supreme Court for pushing "the fulcrum point between director authority and accountability too far in favor of director authority" under the new good faith doctrine, particularly in the context of monitoring a corporation's legal compliance and business risks. *Id.* at 235. In her view, "[t]he current doctrinal approach has created a 'toothless tiger'—an eviscerated standard that in practice rarely poses any meaningful threat of liability absent a violation of law—warranting a revision to the standard of oversight liability. *Id.* at 215–16. She proposes a "five factor red flag test" in examining director liability in the oversight context. "The five factors are: (1) the potential harm to the company; (2) the time directors had to react; (3) the particular source of the red flag; (4) the frequency of the red flag; and (5) the availability of relevant information to the directors." If a court finds that a red flag existed under five-factor test and directors failed to take appropriate steps, it should impose liability for a breach of good faith. *Id.* at 207; Bishop, *supra* note 807, at 934 (criticizing Delaware's new good faith doctrine and arguing that "[a] more plausible role for good faith would be not to make it an actionable independent standard, but to relegate it to a status that simply defeats" the protections of the business judgment rule and exculpatory provisions").

[934] Larry Ribstein, The Disney Affirmance: The End of the SOX Era http://busmovie.typepad.comideoblog/2006/06/thedisney-affi.html (June 8, 2006, 10:08 PST) (quoted from Bainbridge et. al., *supra* note 859, at 589 n.159).

[935] *Disney IV*, 907 A.2d at 750 n.29 (quoting Guttman v. Huang, 823 A.2d 492, 507 n. 39 (Del.Ch. 2003)) (emphasis in original).

Accordingly, the gross negligence standard puts a nearly insurmountable barrier in front of plaintiffs. Requiring a showing of worse dereliction than grossly negligent conduct does not provide plaintiffs a meaningful opportunity to challenge directors' decision-making process or oversight failures under good faith. The distinction between the gross negligence standard and bad faith makes sense as a general matter; however, it has little, if any, application in practice.

The new good faith doctrine and the relevant standard may not be sufficient to assure director engagement or attentiveness in either corporate decision-making or oversight. By taking minimal procedural steps in discharging their responsibilities, directors may avoid personal liability under the new good faith standard. In the decision-making context, for example, if directors hold a meeting and make a cursory discussion of the issue at hand, they would not have consciously or intentionally disregarded their responsibilities.[936] A superficial performance of minimal proceduralist responsibilities may preclude a finding of bad faith; however, it is far from the conduct expected of directors in performing board service. While good faith requires a genuine effort to comply with the fiduciary duties, directors may avoid personal liability by meeting minimal proceduralist standards of attention.

The situation is not much different in the oversight context.[937] The standard of liability in this context had been previously articulated by the Chancery Court in *In re Caremark International Inc. Derivative Litig.*[938] There, the Chancery Court held that sustained and systematic failure to discharge oversight responsibilities may indicate lack of good faith and result in personal liability.[939] In *Stone*, the Delaware Supreme Court affirmed *Caremark* and took it one step further. The *Stone* court held that "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."[940] Accordingly, after *Stone*, there is room for directors to escape personal liability by arguing that they did not know

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[936] *See* Furlow, *supra* note 450, at 1077–79 (arguing that the concept of dereliction of duty was developed in cases dealing with oversight failures, and it would have rare application in the decision-making context).
[937] *See, e.g.,* Knees, *supra* note 933, at 205 ("In theory, directors face potential liability for failed oversight. But in practice it is viewed as an unworkable and virtually meaningless standard where liability exists only within a very narrow procedural footing.").
[938] 698 A.2d 959, 971 (Del. Ch. 1996).
[939] *Id.*
[940] *Stone*, 911 A.2d at 370.

they were not discharging their responsibilities, even though their conduct constituted sustained and systematic failure of oversight obligations.[941]

Commentators also raised concerns that Delaware's new good faith standard lacks clarity.[942] In *Disney*, the Delaware Supreme Court held that the conscious disregard standard intends to capture the conduct that is short of intentional misconduct but is worse than lack of due care (grossly negligent conduct).[943] This distinction makes sense doctrinally; however, it is hard to depict a factual setting that would fall within this grey area. In the absence of provable subjective bad faith (smoking gun memorandum), it is not clear how a plaintiff can demonstrate such conduct. Although the *Disney* court provided some conceptual guidance by clarifying that bad faith requires worse dereliction than grossly negligent conduct, the court did not provide an explanation as to what a plaintiff is required to do to demonstrate such conduct.[944] Gross negligence itself is a nebulous standard, and suggesting that unintentional bad faith must be worse than gross negligence is not helpful. As one commentator observed, "measures framed in terms of exceeding gross negligence, but less than intentional negligence, are not particularly useful."[945] Another observed that the "murky" distinction between exculpable gross negligence and non-exculpable bad faith—a distinction that is "virtually impossible to draw in abstract, let alone in concrete, terms—would be rendered entirely moot."[946]

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[941] *See supra* note 921 & accompanying text. *But see* Bishop, *supra* note 807, at 937 (stating that the *Stone* court "did not define the precise contours of when oversight failure is systemic and actionable" and that this approach would encourage directors to take affirmative steps to be more involved in the oversight of the corporations).

[942] *See, e.g.*, Hill & McDonnell, *supra* note 885, at 834, 855 (stating that the Delaware Supreme Court "created space for a doctrine of good faith, but it provided little guidance as to how that doctrine might work, even in cases like *Disney V* itself" and that Delaware courts "have left the duty of good faith too vague to provide any real guidance"); Knees, *supra* note 933, at 235 (stating that the recent good faith doctrine "provide[s] little indication of how [the conscious disregard] standard will be applied or how a court will determine whether or not one's duties were 'consciously' disregarded").

[943] *Disney V*, 906 A.2d at 65.

[944] *See* Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 402 (2007) (stating that the new good faith doctrine "does not tell us how courts should review director decisions, or how to recognize a conscious disregard of a director's responsibilities").

[945] Bishop, *supra* note 807, at 934.

[946] *See* Bruner, *supra* note 835, at 1177 (criticizing the new good faith doctrine by stating "the incoherence of Delaware's fiduciary duty doctrine resulting from the interaction of the bench and the legislature over the course of decades has resulted in a doctrinal framework that is self-contradictory and that, as a practical matter, utterly sacrifices the 'clarity' and 'predictability' upon which Delaware's corporate establishment has long prided itself"); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 31–33 (2005) (stating that tort law distinctions between negligence and intent do not work in the context of board decision-making, and arguing that "intent and recklessness can be characterized as negligence and negligence similarly can be recast as intent"); Strine et al., *supra* note 832, at 695 (observing that "even after Stone v. Ritter, [ ]

After *Disney* and *Stone*, it is clear that the main focus of judicial inquiry into good faith is a director's subjective state of mind.[947] The infusion of good faith into the duty of loyalty requires the judiciary to "ask the question whether a particular director accused of disloyalty has committed a breach by taking action in bad faith."[948] In examining whether a director acted in bad faith, a court "will generally be required to look to the [director's] actions as circumstantial evidence of state of mind."[949] The objective circumstances surrounding a directors' action are highly relevant and important in good faith analysis. However, in addition to a failure to take a specific action or actions, a state of mind that is inconsistent with loyalty is a necessary condition for personal liability. Inattentive conduct constitutes bad faith if the particular director knew that she was not discharging her responsibilities. Accordingly, the objective criterion that "the director should have known that she was not discharging her responsibilities" is mostly excluded from good faith analysis. In the absence of such objective criterion, it is hard to tell whether the new good faith standard would be meaningful for reviewing inattentive director conduct. As Professor Eisenberg observed:

> [The conscious disregard standard] would make little or no sense unless they mean either that the manager was conscious that he was disregarding his duties *or that a reasonable person in the manager's position would have known that he was disregarding his duties—not that the actual manager was subjectively conscious that he was disregarding his duties*. Surely it [should] be no defense in such a case that the manager on being asked, 'Were you consciously disregarding your duties?' truthfully replied, 'No,' or, 'I didn't think about it one way or the other.'[950]

Further, an inquiry into the subjective state of mind of directors necessarily requires inferences to be drawn from the quality of the decision itself.[951] Substantive merits of a business

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there remains controversy over what circumstances generate a genuine inference of bad faith and whether the judiciary is sufficiently distinguishing between concepts of gross negligence and bad faith").

[947] *See* Strine et al., *supra* note 832, at 693; Gold, *supra* note 944, at 423, 426 (stating that the *Disney* test for bad faith (intentional dereliction of duty, a conscious disregard for one's responsibilities) "is a straightforward, subjective standard of conduct" and that the reasoning of the court in *Disney V* "makes clear that bad faith involves the defendants' actual state of mind").

[948] Strine et al., *supra* note 832, at 695. As Strine and his colleagues further explained, the inclusion of good faith in the duty of loyalty "puts plaintiffs to the test of proving that directors who have not engaged in self-dealing acted with a state of mind inconsistent with their duty of loyalty, and fact-finders to the corresponding challenge of delivering defendant-specific answers." *Id.* at 696.

[949] Gold, *supra* note 944, at 429 (quoting No. Civ. A. 20228-NC, 2004 WL 1949290, at *17 n.92 (Del. Ch. Aug. 24, 2004)).

[950] Eisenberg, *supra* note 825, at 72 (emphasis added); *see also supra* note 842–51 & accompanying text (examining Eisenberg's good faith analysis).

[951] *See* Bruner, *supra* note 835, at 1156 ("Analysis of good faith 'call[s] for an ad hoc determination of the board's motives in the particular instance'—an 'inquiry into a subjective state of mind' that would 'require inferences to be drawn from overt conduct,' including 'the quality of the decision made.'") (quoting No. CV-6085, 1988 WL 53322, at *15 (Del. Ch. May 19, 1988)).

decision would naturally play an important role in shaping directors' state of mind. Even though an alleged instance of misconduct involves an egregiously deficient decisional process, directors may provide substantive justifications for their conduct, arguing that they have acted in good faith in approving the challenged decision. In other words, directors' good faith belief with respect to the substantive merits of a business decision may justify their egregiously deficient decisional process. If directors believe in good faith that the decision itself is in the best interests of the corporation, it is difficult to argue that they would have consciously abdicated their responsibilities. In *Disney*, for example, directors' good faith belief that Ovitz would be a valuable employee for the company arguably dominated the judicial inquiry into the challenged decision-making process of the defendant directors.[952] Therefore, judicial review of directors' due care compliance under the conscious disregard standard ultimately converges to an inquiry into the substantive merits of a business decision.

It is well-recognized that, in Delaware law, directors are granted the widest latitude with respect to the substantive merits of a business decision. Under the business judgment rule, Delaware courts review the quality of business decisions under the onerous waste standard. Delaware courts do not interfere with the business judgment of directors unless it is so irrational that is explicable only on the basis of bad faith.[953] Because good faith analysis necessarily includes consideration of the quality of a decision for inquiring into the subjective state of mind of directors, under the conscious disregard standard, a business decision that falls short of the onerous waste standard may justify decisional process failures however egregious they may be.[954] While directors are required to make informed decisions to be afforded the substantive protection of the business judgment rule, there is no such requirement under the conscious disregard standard.

After the introduction of exculpatory provisions into corporate law, the new good faith doctrine emerged as a hope that it would provide necessary discipline for inattentive directors.

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[952] *See supra* Part B.2.a. (examining *Disney*).
[953] Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule."); *see also* Allen, Jacobs & Strine, *supra* note 208, at 452 (describing an irrational decision as "one that is so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it"). Allen's description of an irrational decision assists understanding of the connection between process and substance of a decision in the judicial inquiry into good faith.
[954] *See* Gold, *supra* note 944, at 429–32, 473–74 (proposing the application of the waste/irrationality standard in examining whether a director consciously disregarded his responsibilities).

After *Disney* and *Stone*, it is highly doubtful whether the good faith doctrine and the conscious disregard standard would meaningfully serve this purpose. In pursuit of such purpose, some commentators suggested an independent duty of good faith along with a distinct content from the duty of loyalty. Hillary Sale, for example, had argued that "a breach of good faith need not be intentional or conscious, [but] it does require some sort of obvious, deliberate, or egregious failure."[955] In a similar fashion, Professor Eisenberg proposed that judicial inquiry into good faith should include both objective and subjective standards.[956] In *Disney* and *Stone*, the Delaware Supreme Court rejected this approach.[957] Had the Delaware Supreme Court adopted this approach, the duty of good faith could play a more promising role to incentivize directors for attentive decision-making and oversight. It must be admitted, however, this approach would result in creation of another ambiguous standard, which would require worse dereliction than gross negligence but would differ from it only in degree, not in kind. It would be quite hard to define such a standard. Moreover, it could refresh the fear of personal liability among corporate directors, and the Delaware legislature could enact another statutory provision to permit further limitation of personal liability in addition to section 102(b)(7).[958] Therefore, the Delaware

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[955] Sale, *supra* note 831, at 493.

[956] *See supra* notes 842–51 & accompanying text.

[957] *See* Strine et. al., *supra* note 839, at 632 (stating that the Delaware Supreme Court undermined the doctrinal premise of this approach); Gold, *supra* note 944, at 424. The author observed as follows:

> On its face, the *Disney V* formulation—'intentional dereliction of duty, a conscious disregard of one's responsibilities'—indicates a subjective standard. One does not do something intentionally without being aware of it. But, even if 'conscious' and 'intentional' should mean what Eisenberg contends, the *Disney V* rationale closes off that possibility. A manager who did not know he had disregarded his duties, despite the fact that a reasonable person in his position would have known, is hard to distinguish from a manager who acted with gross negligence. Eisenberg's example is precisely what the Delaware Supreme Court sought to avoid in rejecting gross negligence as a category of 'bad faith' conduct.

Id. (footnotes omitted).

[958] *See* Andrew C. W. Lund, *Opting out of Good Faith*, 37 FLA. ST. U. L. REV. 393, 394 (2010) (proposing the application of a robust version of the conscious disregard standard, coupled with permitting corporations to exculpate director monetary liability under such a standard). The author convincingly argues that "any attempt to calibrate the proper application of conscious disregard was bound to err in one direction or the other" because of the difficulty in differentiating conscious and unconscious acts in the corporate context. *Id.* at 393. He observed as follows:

> [T]he inability to sharply distinguish conscious due care breaches from unconscious ones reintroduces the same costs that led to the adoption of section 102(b)(7) in the first place. If it is difficult for courts to predictably determine directors' states of mind, the requisite line-drawing is liable to be a relatively arbitrary process. As due care bleeds into conscious due care, any advantages gained by permitting due care exculpation begin to evaporate.
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> The difficulty of establishing an appropriate application of the conscious disregard standard was not a hypothetical one. … Drawing the line between gross negligence-the standard of review for

Supreme Court may have followed the right path by subsuming good faith into the duty of loyalty and by articulating a bad faith standard that is qualitatively different and more culpable than gross negligence.

Notwithstanding, after *Disney* and *Stone*, directors of Delaware corporations with a section 102(b)(7) provision face virtually no threat of personal liability for inattentive misconduct that does not involve pecuniary self-interest, fraud, or waste. Section 102(b)(7) and its interpretation by Delaware courts practically eliminates any meaningful threat for disinterested and yet inattentive directors. Because of the emphasis on its subjective aspect, the conscious disregard standard would have rare application in reviewing inattentive corporate decision-making or oversight. The new good faith doctrine and the relevant standard may not be sufficient to assure director engagement or attentiveness. Thus, as one commentator observed, "good faith functions as a rhetorical device rather than a substantive standard. That is, it operates as a speech act, a performance, as opposed to a careful method of analysis."[959]

> due care claims-and conscious gross negligence did, in fact, seem arbitrary. Adjusting the test for conscious disregard at the margins was likely to be an unsatisfactory solution. Any such attempt was bound to be overinclusive or underinclusive with respect to the kinds of claims that would qualify as demonstrating conscious disregard. The former would tend to conflict with the privately ordered preferences against director liability in due care cases, while the latter would tend to eviscerate the new good faith doctrine and any potential advantages of more precise culpability distinctions.

Id. at 395–96. (footnote omitted).

[959] Griffith, *supra* note 946, at 1. Hill and McDonnell argued that the increasing public attention with respect to corporate governance in the twenty-first century and the mixed state/national system of regulating corporate governance may have compelled Delaware courts to redefine the contours of the directors' fiduciary obligations in the post-exculpatory era. They observed as follows:

> Th[e] outline of the politics of the *Disney* cases reflects several important broad patterns. Our mixed federal system of regulating corporate governance creates a variety of political pressures on Delaware, the leading state corporate law jurisdiction. On the one hand, other states stand ready to take corporations away from Delaware should Delaware's rules become too unattractive. On the other hand, federal actors (Congress, the SEC, and the securities exchanges) may preempt many areas of corporate lawmaking if they are unhappy with what Delaware is doing, with Sarbanes-Oxley standing as a leading example of national action. Different affected interest groups have differing abilities to affect rulemaking at the state and federal levels. Managers and corporate lawyers tend to have more influence at the state level, whereas shareholders and perhaps other constituencies such as creditors and employees do better politically at the national level. The specialization of Delaware courts and the experimentation that occurs among the states also tends to lead to higher-quality rulemaking in Delaware. The mixed federal system thus allows much corporate lawmaking to be done by highly expert bodies, Delaware courts, while the threat of preemption by the SEC and Congress helps keep in check the tendency towards managerial bias to which Delaware is prone.
>
> The differing interest groups push the law in different directions; managers and corporate lawyers tend to push towards limited and enabling regulation on most matters, while shareholders and other constituencies tend to push for more expansive and mandatory regulation. The relative

> strength of these groups varies over time, in part in response to how well things are going in the area of corporate governance. Thus, in the late-1990s stock prices were booming and the dot-corns seemed to be leading a vigorous and innovative economy. In the early years of this decade, in contrast, the corporate scandals and capital market downturn made things look bleaker. Shareholder activists became a more powerful political force as they looked for ways to reform the system. One can see this as a useful learning process—problems arise, they generate pressure for change, and the regulators generate new solutions. A more cynical view sees a cycle driven by the availability bias—constituents and politicians panic when scandals dominate the press, then they become overly complacent in times when few corporate scandals have received recent attention. Both of these views strike us as partly right—they are not mutually exclusive.

Hill & McDonnell, *supra* note 885, at 848 (footnotes omitted).

CHAPTER V. SHAREHOLDER DERIVATIVE SUITS AND THE DIRECTOR DEMAND REQUIREMENT

A. The Dual Nature of Derivative Suits

1. A Corporate Cause of Action

The fundamental statutory corporate principle is that the authority to manage the business and affairs of a corporation belongs to its board of directors.[960] As a corollary to this principle, it is within the authority of a board to decide whether or not to pursue a legal claim belonging to the corporation. The derivative action is a common law exception to this principle. It is a "method by which shareholders may seek redress on behalf of the corporation for an alleged harm caused by the misuse of managerial power."[961] Equity developed the derivative action to enable shareholders to litigate a corporate cause of action where those in the control of the corporation refuse to do so.[962] For example, it is unlikely that directors will institute litigation to enforce a corporate cause of action which involves fiduciary claims against themselves.[963] Similarly, directors will rarely bring a lawsuit against one of their colleagues or executive officers for a breach of a fiduciary duty. To protect a corporation's interests in these types of situations, courts permit minority shareholders "to enforce a *corporate* cause of action against officers, directors, and third parties" by bringing a derivative action.[964] As the Supreme Court of the United States explained, "[d]evised as a suit in equity, the purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'"[965]

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[960] *See* DEL. CODE ANN. tit. 8, § 141(a) (2011).

[961] Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995) (footnote omitted).

[962] *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("[A] stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid and unfaithful management."); Andrew C.W. Lund, *Rethinking Aronson: Board Authority and Overdelegation*, 11 U. PA. J. BUS. L. 703, 709 (2009) (observing that the derivative action is an important device "by which shareholders can minimize agency costs that arise in widely-held corporations").

[963] *See* EISENBERG & COX, *supra* note 1, at 1011 (observing that "[i]f the fiduciary duties owed by directors, officers, and controlling shareholders could be enforced only in suits by the corporation, many wrongs would never be remedied").

[964] Kamen v. Kemper Fin. Serv., Inc., 500 U.S. 90, 95 (1991) (quoting Ross v. Bernhard, 396 U.S. 531, 534 (1970)) (emphasis in original).

[965] *Id.* at 95 (quoting Cohen v. Beneficial Indus. Loan Corp. 337 U.S. 541, 548 (1949)). *See also* Agostino v. Hicks, 845 A.2d 1110, 1116 (Del. Ch. 2004) The Delaware Chancery Court explained the policy underlying derivative actions as follows:

> Generally a cause of action belonging to a corporation can be asserted only by the corporation. However, whenever a corporation possesses a cause of action which it either refuses to assert or,

In a derivative action, a "shareholder's right to bring the suit derives from the corporation."[966] The legal claim brought in a derivative action belongs to the corporation, not to the shareholder bringing the action. It is the corporation which suffers the injury from the complained of action, and the requested remedy must go to the corporation. As the residual owners of the corporation, shareholders suffer an indirect harm because the direct injury to the corporation "depletes corporate assets, and affects the shareholder only by reducing the value of his stock."[967] In a derivative action a plaintiff-shareholder "'stands in the shoes of the corporation'"[968] in order to redress the injury suffered by the corporation. Accordingly, a derivative action involves two claims: "the [shareholder] plaintiff's right to sue on behalf of the corporation" and "the merits of the corporation's claim itself."[969] As the Delaware Supreme Court explained in *Aronson*: "[t]he nature of the [derivative] action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it."[970]

Shareholders can bring a direct action on their own behalf against either corporate fiduciaries or the corporation itself if they suffer a direct injury. For example, a wrongful act that does not harm the corporation yet interferes with shareholder voting or pre-emptive rights may be brought as a direct action by the injured shareholders. The Delaware Supreme Court explained the difference between a derivative and direct action as follows:

> [The derivative action] enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation. Because a derivative suit is being brought on behalf of the corporation, the recovery: if any, must go to the corporation. A stockholder who is directly injured, however, does retain the right to bring an individual action for injuries affecting his or her legal rights as a stockholder. Such a claim is distinct from an injury caused to the corporation alone. In such individual suits, the recovery or other relief flows directly to the stockholders, not to the corporation.[971]

> by reason of circumstances, is unable to assert, equity will permit a stockholder to sue in his own name for the benefit of the corporation solely for the purpose of preventing injustice when it is apparent that the corporation's rights would not be protected otherwise.

Id. (quoting Taormina v. Taormina Corp., 78 A2d 473,475 (Del. Ch. 1951)).
[966] EISENBERG & COX, *supra* note 1, at 1011.
[967] *Id*. at 1030. *See also id*. at 1030–31 (examining actions that can be characterized as either direct or derivative).
[968] Elf Atochem North Am., Inc. v. Jaffari, 727 A.2d 286, 293 n.39 (Del. 1999) (quoting Schleiff v. Baltimore & Ohio R.R. Co., 130 A.2d 321, 327 (Del. Ch. 1955)).
[969] Ross v. Bernhard*,* 396 U.S. 531, 534–35 (1970).
[970] *Aronson,* 473 A.2d at 811.
[971] Tooley v. Donaldson, Lufkin & Jenrette Inc., 845 A.2d 1031, 1036 (Del. 2004).

Whether an action is derivative or direct has important legal consequences. The derivative action is subject to special procedural rules.[972] To prevent abuse of the derivative action, the law requires shareholders to comply with "exacting procedural prerequisites" in bringing a derivative action.[973] For example, in a derivative action shareholders are required to: "(a) retain ownership of the shares throughout the litigation; (b) make presuit demand on the board; and (c) obtain court approval of any settlement."[974] In contrast, the special rules governing the derivative action do not apply to a shareholder direct action. Accordingly, plaintiff-shareholders may be incentivized to characterize their claims so as to state a direct action to avoid the procedural hurdles of a derivative action. However, the "[p]laintiff's classification of the suit is not binding," and "[t]he [c]ourt will independently examine the nature of the wrong alleged and any potential relief to make its own determination of the suit's classification."[975]

The Delaware Supreme Court in *Tooley* held that the analysis for determining whether a claim is derivative or direct "must be based *solely* on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?"[976] The *Tooley* court also acknowledged that its prior jurisprudence included concepts that were confusing and not helpful in distinguishing whether an action is derivative or direct, and they should be regarded as erroneous.[977] First, the court addressed the "special injury" rule. Special injury had been defined as "a wrong that 'is separate and distinct from that suffered by other shareholders, … or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation.'"[978] The court observed that this analysis is "is not helpful to a proper analytical distinction between direct and derivative actions."[979] Second, the court addressed the corollary principle that "a suit must be maintained derivatively if the injury falls equally upon all stockholders."[980] The court explained that this concept is

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[972] *See infra* Part B., C.
[973] *Agostino*, 845 A.2d at 1117.
[974] *Tooley*, 845 A.2d at 1036.
[975] *Id.* (quoting *Tooley*, 2003 WL 203060, at *3).
[976] *Id.* (emphasis added).
[977] *Id*. at 1032.
[978] *Id*. at 1035 (quoting Tooley, 2003 WL 203060, at *3 (citing Moran v. Household Int'l. Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985), *aff'd* 500 A.2d 1346 (Del. 1986))).
[979] *Id*.
[980] *Id*. 1037. The Delaware Supreme Court had previously used this analysis in Bokat v. Getty Oil Co., 262 A.2d 246 (Del. 1970).

confusing, and it is also inaccurate "because a direct, individual claim of stockholders that does not depend on harm to the corporation can also fall on all stockholders equally, without the claim thereby becoming a derivative claim."[981] The court expressly disapproved the use of both concepts and limited the test for determining whether an action is derivative or direct to the injury-remedy analysis.[982] Thus, if the harm is suffered by, and the potential remedy belongs to, the corporation, the complaint should be classified as derivative.

2. The Plaintiff-Minority Shareholder's Standing to Bring the Action

A plaintiff-shareholder must own stock at the time of the alleged wrongful act and throughout the course of the litigation to have standing to bring a derivative action. The requirement that a plaintiff be a stock owner at the time of the complained act is called the "contemporaneous ownership rule", and the requirement that a stockholder retain shareholder status throughout the litigation is called "continuous ownership rule."[983] A plaintiff-shareholder must satisfy both tests to have standing to commence and maintain a derivative action.[984]

The contemporaneous ownership requirement is codified under Section 327 of the General Delaware Corporation Law as follows:

> In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.[985]

Similarly, Delaware Court of Chancery Rule 23.1(a) provides in its pertinent part:

> In a derivative action brought by one or more shareholders … to enforce a right of a corporation …, the corporation … having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder … at the time of the transaction of which the plaintiff complains or that the plaintiff's share …. thereafter devolved on the plaintiff by operation of law. [986]

Accordingly, where a plaintiff became a shareholder after the alleged wrongdoing occurred, generally the plaintiff has no standing to bring a derivative claim concerning that wrongdoing.

Section 327 and Rule 23.1 provide an exception to the contemporaneous ownership requirement. If a plaintiff obtains her shares by operation of law, she can bring a derivative suit

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981 *Id.*
982 *Id.* at 1039.
983 *See* Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 935 (Del. Ch. 2008) (footnotes omitted).
984 *Id.*
985 DEL. CODE ANN. tit. 8, § 327.
986 DEL. CT. C.P.R. 23.1.

for an alleged wrongdoing that occurred prior her acquisition of the stock.[987] For example, a plaintiff who obtains the stock of a corporation by inheritance is permitted to bring a derivative complaint for a wrongful act that occurred before she became a stock owner of the corporation.[988] Another exception to the contemporaneous ownership requirement is provided by the common law: "continuing-wrong" doctrine.[989] The Delaware Chancery Court in *Desimone v. Barrows* defined the scope of the continuing wrong doctrine as "a narrow one that typically is applied only in unusual situations, such as where a plaintiff acquires his stock after a particular transaction has begun but before it is completed."[990] The *Desimone* court further explained that this doctrine is not "a sweeping exception to the contemporaneous ownership requirement", and it "does not bestow standing upon a stockholder to challenge transactions occurring before he bought his stock simply because they are similar or related to transactions or other conduct that occurred later."[991]

The purpose of the contemporaneous ownership requirement is to eliminate potential abuse of a derivative action as a strike suit. As the Delaware Supreme Court explained, it "prevent[s] strike suits whereby an individual purchases stock in a corporation with purely litigious motives, *i.e.,* for the sole purpose of prosecuting a derivative action to attack transactions which occurred prior to the purchase of stock."[992] It should be noted that even if a shareholder does not purchase the stock for such a purpose; she is not allowed to bring a derivative action for a wrongful act that occurred prior the purchase of the stock. As the Delaware Chancery Court stated in *Desimone v. Barrows*:

> Although this court has often recognized that a primary purpose of § 327 is to prevent plaintiffs from buying stock in order to maintain a derivative suit, there is no indication in the unambiguous text of the statute that that is its only purpose or that a plaintiff has standing when he otherwise would not simply because he was ignorant of the wrongdoing before he acquired the stock. This court cannot supplant the plain language of a Delaware statute with conjecture about that statute's underlying public policy. … [D]ecisions of this court that merely attempt to explain the statute … could not and did not alter the plain language of the statute. Section 327 is clear that stock

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[987] *Parfi*, 954 A.2d at 937 (describing by operation of law exception as "[a] transfer of shares … that the shareholder acquires the shares *without* any act or cooperation on his or her part") (quoting WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5981 (2004)) (emphasis in original).
[988] *See* EISENBERG & COX, *supra* note 1, at 1046.
[989] *Id*. *See also id*. (examining section 16(b) exception to the contemporaneous ownership requirement under federal law).
[990] 924 A.2d 908, 924–25 (Del. Ch. 2007).
[991] *Id*. at 925.
[992] *Alabama By-Products*, 657 A.2d 254, 264 n.12 (citation omitted).

> ownership at the time of challenged conduct is a prerequisite to maintaining a derivative action and the General Assembly has not legislated a 'state of mind exception' to that requirement.[993]

Section 327 and Rule 23.1 do not explicitly require a plaintiff-shareholder to maintain stock ownership during the pendency of a derivative action. However, the common law imposes the continuous ownership requirement as an extension of the contemporaneous ownership doctrine.[994] As the Delaware Supreme Court stated, a plaintiff-shareholder is permitted to bring a derivative action "only because his status as a shareholder provides an interest and incentive to obtain legal redress for the benefit of the corporation."[995] Accordingly, a plaintiff-shareholder loses standing in a derivative action "once she ceases to be a stockholder in the corporation on whose behalf the suit was brought, [because] [s]he no longer has a financial interest in any recovery pursued for the benefit of the corporation."[996]

An implication of the continuing ownership rule in the merger context is that "when a merger eliminates a plaintiff's shareholder status in a company, it also eliminates her standing to pursue derivative claims on behalf of that company."[997] As the Delaware Supreme Court explained in *Lewis v. Ward*:

> [A] merger which eliminates a complaining stockholder's ownership of stock in a corporation also ordinarily eliminates his status to bring or maintain a derivative suit on behalf of the corporation, whether the merger takes place before or after the suit is brought, on the theory that upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action.[998]

The Delaware Supreme Court recognized two exceptions to the continuous ownership requirement in the merger context: first, "if the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive shareholders of the standing to bring a derivative action; or [second] if the merger is in reality merely a reorganization which does not affect plaintiff's ownership in the business enterprise."[999]

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[993] 924 A.2d at 926–27 (footnotes omitted).
[994] *See, e.g., Alabama By-Products*, 657 A.2d at 265; Lewis v. Anderson, 477 A. 2d 1040, 1046 (Del. 1984); Lewis v. Ward, 852 A.2d 896, 901 (Del. 2004).
[995] *Alabama By-Products*, 657 A.2d at 265.
[996] *Id.*
[997] *Ward*, 852 A.2d at 901.
[998] *Id.* (quoting Schreiber v. Carney, 447 A.2d 17, 21 (Del.Ch.1982)).
[999] *Id.* (quoting Kramer v. Western Pac. Indus., Inc., 546 A.2d 348, 354 (Del.1988) (citing *Lewis*, 477 A.2d at 1046 n.10)).

B. The Director Demand Requirement

1. The Purpose of the Director Demand Requirement

The basic statutory corporate norm is that the authority to manage the business and affairs of a corporation belongs to its board of directors.[1000] Under usual circumstances, it is within the ambit of directors' managerial authority to initiate or to refrain from initiating a legal action on behalf of the corporation.[1001] The derivative action constitutes an exception to the directorial power concerning the pursuit of a corporate claim. As the Delaware Supreme Court observed, "[b]y its very nature the derivative action impinges on the managerial [power] of directors."[1002] "There is, …, the potential for conflict between the directors' power to manage the corporation and the shareholders' power to sue derivatively."[1003] In recognition of this conflict, the law imposes the demand requirement on a shareholder's right to bring a derivative action on behalf of the corporation. As one commentator nicely put it, "[t]he demand requirement is a natural outgrowth of the authority that corporate law vests in the board to make corporate decisions, including litigation decisions."[1004]

Delaware Court of Chancery Rule 23.1 requires a derivative complaint to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [or] the reasons for the plaintiff's failure to obtain the action or for not making the effort."[1005] Accordingly, a shareholder is required to make a pre-suit demand on the board of directors to pursue a corporate claim. Or, alternatively, she is required to demonstrate that such a demand would be futile and, therefore, should be excused. Under the demand requirement, a shareholder is not permitted to bring a derivative action to enforce the unasserted rights of a corporation unless she "(a) has first demanded that the directors pursue the corporate claim and the directors have wrongfully refused to do so; or (b) establishes that pre-suit demand is excused because the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation."[1006]

[1000] *See* DEL. CODE ANN. tit. 8, § 141(a).
[1001] *Alabama By-Products*, 657 A.2d at 254.
[1002] Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).
[1003] *Alabama By-Products*, 657 A.2d at 265 (quoting Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 729 (Del. 1988)).
[1004] Lund, *supra* note 962, at 703–4.
[1005] DEL. CT. C.P.R. 23.1
[1006] Wood v. Baum, 953 A.2d 136, 140 (Del. 2008).

When a demand is made, it gives the board of directors an opportunity to investigate the merits of the corporate claim and to exercise its business judgment whether the pursuit of the claim will serve the best interests of the corporation.[1007] If the directors refuse to take action, the plaintiff must demonstrate that it was a wrongful refusal. Where no demand was made, the plaintiff must demonstrate that the directors were incapable of reaching an impartial decision regarding whether or not to pursue the corporate claim. Accordingly, the demand requirement is "designed to ensure that through derivative suits 'shareholders do not improperly seize corporate powers.'"[1008] In short, it reinforces the norm of management by directors in the context of shareholder derivative actions. As the Delaware Supreme Court stated, "the demand requirement is a recognition of the fundamental statutory precept that section l41(a) vests boards of directors with the power to manage the business and affairs of corporations."[1009]

2. The Relation of the Director Demand Requirement to the Business Judgment Rule

The demand requirement recognizes the basic corporate norm that directors rather than shareholders are empowered to manage the business and affairs of a corporation. Likewise, the business judgment rule is "an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)."[1010] The business judgment rule protects directors by providing a defense to the merits of a suit that involves a claim of a fiduciary breach.[1011] It is the primary standard of review that directs judicial inquiry into director behavior in the decision-making context. It presumes that directors exercise sound business judgments upon complying with their fiduciary duties.[1012] The business judgment rule also plays an important role in the pre-trial stage of a shareholder derivative action. As the Delaware Supreme Court stated, "[b]ecause …

[1007] *See Aronson*, 473 A.2d at 809 (stating that the demand requirement is "a rule of substantive right designed to give a corporation the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise") (citation omitted).
[1008] Braddock v. Zimmerman*,* 906 A.2d 776, 785 (Del. 2006) (citation omitted).
[1009] *Id*. at 784. *See also Aronson,* 473 A.2d at 811–12 (stating that the demand requirement "promotes … alternate dispute resolution, rather than immediate recourse to litigation" by "insur[ing] that a stockholder exhausts his intracorporate remedies" and "it provide[s] a safeguard against strike suits" that are brought not to remedy a corporate wrong but for their settlement or harassment value); White v. Panic, 793 A.2d 356, 364 (Del. Ch. 2000) ("The purpose for the demand requirement and concomitant heightened pleading standard is to 'effectively distinguish between strike suits motivated by the hope of creating settlement leverage through the prospect of expensive and time-consuming litigation discovery and suits reflecting a reasonable apprehension of actionable director malfeasance that the sitting board cannot be expected to objectively pursue on the corporation's behalf.'") (citation omitted).
[1010] *Aronson*, 473 A.2d at 812.
[1011] *Id.*
[1012] *Id.*

derivative suits challenge the propriety of decisions made by directors pursuant to their managerial authority, … the stockholder plaintiffs must overcome the powerful presumptions of the business judgment rule before they will be permitted to pursue the derivative claim."[1013] Accordingly, the business judgment rule also shapes judicial inquiry to review whether a shareholder challenging a business decision met the demand requirement. First, where a demand was made and refused, the refusal is subject to judicial review under the business judgment rule standard.[1014] Second, where no demand is made, the business judgment rule plays an eminent role in the determination of demand futility.[1015] Thus, "[t]he function of the business judgment rule is of paramount significance in the context of a derivative action."[1016]

3. Heightened Pleading Requirements

In a demand refused or demand excusal case, a plaintiff is required to comply with stringent pleading requirements. Rule 23.1 provides:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [or] the reasons for the plaintiff's failure to obtain the action or for not making the effort.[1017]

Accordingly, a plaintiff must plead particularized facts in claiming that demand is excused, or if made and refused, the refusal was wrongful. Vague or "conclusory statements or mere notice pleading" does not suffice to comply with Rule 23.1.[1018] The pleading standard that applies to derivative complaints is "an exception to the general notice pleading standard."[1019] It is stricter than the notice pleading standard that governs non-derivative claims.[1020] In *Brehm v. Eisner*, the Delaware Supreme Court stated that "[p]leadings in derivative suits… must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings" permitted in other types of cases.[1021] The *Brehm* court further stated that the particularized factual statements in a derivative complaint must also be "'simple, concise and

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[1013] Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993).
[1014] *Aronson,* 473 A.2d at 813.
[1015] *Id*. at 812.
[1016] *Id.*
[1017] DEL. CT. C.P.R. 23.1
[1018] Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).
[1019] Levine v. Smith, 591 A.2d 194, 210 (Del. 1991).
[1020] Malpiede v. Townson, 780 A.2d 1075, 1083 (Del. 2001). ("[The general] 'notice pleading' requirement [is] less stringent than the standard applied when evaluating whether a pre-suit demand has been excused in a stockholder derivative suit filed pursuant to Chancery Rule 23.1.").
[1021] *Brehm,* 746 A.2d at 254.

direct.' A prolix complaint larded with conclusory language, …, does not comply with these fundamental pleading mandates."[1022] As the Delaware Chancery Court stated:

> Generalities, artistically ambiguous, all-encompassing conclusory allegations are not enough. What is required are pleadings that are specific and, if conclusory, supported by sufficient factual allegations that corroborate the conclusion and support the proposition that demand is futile.[1023]

Thus, the stringent pleading requirements for a derivative complaint put a very difficult, if not insurmountable, burden on the plaintiff-shareholder.[1024] A failure to comply with these high pleading standards requires the dismissal of a derivative complaint. The Delaware Supreme Court stated that the reason behind the heightened pleading requirements is to prevent "a stockholder to cause the corporation to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation."[1025] As Delaware courts recognized in numerous cases, it is very difficult for a plaintiff to survive a motion to dismiss a derivative action based on the plaintiff's failure to satisfy the demand requirement.[1026]

C. Demand Excusal: Futility

1. Decision–Making Cases

Shareholders are allowed to bring a derivative action without making a pre-suit demand on the board of directors if such a demand would be futile. A pre-suit demand is excused if directors are incapable of reaching an impartial decision regarding the pursuit of the perceived corporate wrong. "Where directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation."[1027] In such instances, the futility exception to the demand requirement "allows board authority to be overridden … in order that fiduciary duties remain enforceable."[1028] Indeed, in most cases, shareholders attempt to litigate derivative claims without making a pre-suit demand on directors,

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[1022] *Id.*
[1023] Richardson v. Graves, 1983 Del. Ch. LEXIS 466, at * 5 (Del. Ch. June 17, 1983).
[1024] *Brehm,* 746 A.2d at 254.
[1025] *Id.* at 255.
[1026] *See* 3 RADIN, *supra* note 161, at 3870 n.1465 & 1466 (citing the Delaware cases in this regard). It should be also noted that discovery is not allowed in a demand refused or excusal case. *See, e.g.,* Scattered Corp. v. Chi. Stock Exch., Inc., 701 A.2d 70, 77 (Del. 1997) (stating that "[a] plaintiff's standing to sue in a derivative suit, whether based on demand-refused or demand-excused, must be determined on the basis of the well-pleaded allegations of the complaint" and that "plaintiffs in a derivative suit are not entitled to discovery to assist their compliance with the particularized pleading requirement of Rule 23.1 in a case of demand refusal").
[1027] *Aronson*, 473 A.2d at 814.
[1028] Lund, *supra* note 962, at 704.

arguing that the demand would be futile and, therefore, should be excused.[1029] Therefore, demand futility plays an important role in derivative litigation.

In *Aronson*, the Delaware Supreme Court articulated the standard to determine demand futility where a decision is challenged in a derivative suit. The *Aronson* court started its analysis by stating that, in the decision-making context, "demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability."[1030] The court then provided that demand should be excused as futile if the derivative complaint pleads particularized facts creating a reasonable doubt that: "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[1031] The court also stated that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors."[1032] Rather, a showing of "a substantial likelihood of director liability" is required to challenge disinterestedness or independence of directors.[1033] A substantial likelihood of director liability also exists if the challenged transaction is so egregious on its face that it cannot meet the business judgment test.[1034] In other words, a particularized pleading of waste excuses the director demand requirement.

Accordingly, the *Aronson* court articulated a two-pronged test to determine demand futility. Under the first prong, the well-pleaded facts must create a reasonable doubt as to the disinterestedness or independence of a *majority* of the board concerning the challenged decision.[1035] The basis for demand futility under the first prong is that either "(1) a majority of the board has a material financial or familial interest; [or] (2) a majority of the board is incapable of acting independently for some other reason such as domination or control."[1036] The interestedness "may be shown by demonstrating a potential personal benefit or detriment to the

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[1029] *Id.* at 712 n.44. *See also Blasband*, 634 A.2d at 933 (stating that "stockholders often do not make a demand on the board of directors, and instead file suit claiming that demand is excused").
[1030] *Aronson*, 473 A.2d at 812.
[1031] *Id.* at 814. *See* Lund, *supra* note 962, at 714–20 (criticizing the second prong of the *Aronson* test and arguing that judicial inquiry should focus on the first prong in the determination of demand futility).
[1032] *Aronson*, 473 A.2d at 815.
[1033] *Id.*
[1034] *Id.*
[1035] *Id.* 814–15. *See also* Brehm v. Eisner, 746 A.2d 244, 257 (Del. 2000) ("[T]he issues of disinterestedness and independence involved in the first prong of *Aronson* are whether a *majority* of [a] Board, …, [is] disinterested and independent.") (emphasis added).
[1036] Beam v. Stewart, 845 A.2d 1040, 1049 n.20 (Del. 2004) (quoting Grimes v. Donald, 673 A.2d 1207, 1216 (Del.1996)).

[majority of] director[s] as a result of the decision."[1037] For example, a demand will be excused if the challenged transaction is between the corporation and the majority of its board of directors. If the directors' independence is challenged, "a plaintiff must show that the [majority of the] Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the [majority of the] Board is so under his influence that its discretion is 'sterilized.'"[1038] The inquiry into independence is whether the majority of the defendant directors' "decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences"[1039] and, therefore, whether a majority of the board is capable of making an objective evaluation in responding to a demand.[1040] Personal and professional friendships between directors may be considered to affect the disinterested directors' independence in approving their colleagues' interested transactions if the relationship rises to "a bias-producing" level.[1041]

If a plaintiff is unable to satisfy the threshold test either by showing a disqualifying interest or lack of independence of a majority of the board, she must satisfy the second prong for demand to be excused. Under the second prong, the plaintiff must plead particularized facts creating a reasonable doubt "as to the 'soundness' of the challenged transaction" sufficient to rebut the business judgment rule presumption.[1042] In other words, well-pleaded facts must raise a reasonable doubt that the business judgment rule protection is applicable to the actions of the defendant directors. In *Brehm v. Eisner*, the Delaware Supreme Court stated that the demand will be excused under the second prong of *Aronson* if "the particularized facts in the complaint create a reasonable doubt [as to] the informational component of the directors' decisionmaking process."[1043] In sum, under the *Aronson* test, "[t]he premise of a shareholder claim of futility of demand is that a majority of the board of directors either has a financial interest in the challenged transaction or lacks independence or otherwise failed to exercise due care."[1044]

[1037] *Id.* at 1049.
[1038] *Levine*, 591 A.2d at 205 (citation omitted).
[1039] *Aronson,* 473 A.2d at 816.
[1040] *Beam,* 845 A.2d at 1049.
[1041] *Id.* at 1050. The *Beam* court explained that "[a] doubt might arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis à vis an interested director." *Id.* at 1051.
[1042] *Levine,* 591 A.2d at 206.
[1043] 746 A.2d 244, 259 (Del. 2000); *cf. Aronson,* 473 A.2d 814 (stating that the inquiry under the second prong of demand futility test (the business judgment inquiry) relates to "the substantive nature of the challenged transaction and the board's approval thereof").
[1044] *Levine,* 591 A.2d at 205.

2. Monitoring/Oversight Cases

In *Rales v. Blasband*, the Delaware Supreme Court articulated the standard to determine demand futility where a derivative complaint involves allegations regarding nonfeasance or oversight failures of directors.[1045] The *Aronson* test is not appropriate in this context because "[t]he essential predicate for the *Aronson* test is the fact that a *decision* of the board of directors is being challenged in the derivative suit."[1046] The *Aronson* demand futility test is predicated upon the concept of the business judgment rule. Basically, in order for demand to be excused under the *Aronson* test, a plaintiff must plead particularized facts raising a reasonable doubt that the business judgment rule presumption is applicable to the challenged decision. The business judgment rule, however, has no application if the alleged wrongdoing relates to an unconsidered failure to act. As the *Aronson* court stated, "the business judgment rule operates only in the context of director action. … [I]t has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."[1047] Therefore, the *Aronson* test is not applicable in the determination of demand futility in oversight cases.

The *Rales* court held that, where the *Aronson* test is not applicable,[1048] a court should determine demand futility by "examin[ing] whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations."[1049] The *Rales* court further explained:

> [A] court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile."[1050]

Accordingly, the inquiry under the *Rales* demand futility test is whether a complaint "raises a reasonable doubt regarding the ability of a *majority* of the [b]oard to exercise properly

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[1045] 634 A.2d 927 (Del. 1993).
[1046] *Id.* at 933 (emphasis in original).
[1047] *Aronson*, 473 A.2d at 813.
[1048] The *Rales* court identified three principal scenarios that the *Aronson* demand futility test is not appropriate:

> (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where, as here, the decision being challenged was made by the board of a different corporation.

Rales, 634 A.2d at 933–34 (footnotes omitted).
[1049] *Id.* at 934.
[1050] *Id*.

its business judgment in a decision on a demand had one been made at the time th[e] action was filed."[1051] The *Rales* court also reiterated the *Aronson* court's proposition that "the mere threat of personal liability, standing alone, is insufficient to challenge either the independence or disinterestedness of directors...."[1052] Rather, a complaint must challenge the independence or disinterestedness of directors by pleading with particularity facts indicating "a substantial likelihood" of director liability exists.[1053] Thus, for demand to be excused in an oversight case, a derivative complaint must raise a reasonable doubt that a majority of the board is capable of evaluating a demand in a disinterested and independent manner.

3. Exculpatory Provisions and Substantial Likelihood of Liability

Section 102(b)(7) of the Delaware General Corporation Law permits a certificate of incorporation to include a provision exculpating directors from liability for money damages for a breach of the duty of care.[1054] If a certificate of incorporation includes such a provision, a plaintiff who brings a derivative action for money damages must plead non-exculpated claims for demand excusal. In a demand futility case, a plaintiff basically alleges that a majority of a the board of directors is incapable of making an impartial decision regarding the pursuit of a corporate claim. If the basis for the plaintiff's demand futility claim is that the substantial likelihood of liability would taint directors' judgment, she must then plead particularized facts creating a reasonable doubt that the alleged misconduct is protected by an exculpatory provision. As the Delaware Chancery Court explained, where directors are exempted from liability by an exculpatory provision, "the risk of liability does not disable them from considering a demand fairly unless particularized pleading permits the court to conclude that there is a substantial likelihood that their conduct falls outside the exemption."[1055] Similarly, the Delaware Supreme Court stated that, if directors are exculpated from liability for certain conduct, "a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the directors based on particularized facts."[1056]

[1051] *Id.* at 937 (emphasis added).
[1052] *Id*. at 936 (quoting *Aronson*, 473 A.2d at 815).
[1053] *Id.* (quoting Aronson, 473 A.2d at 815).
[1054] *See* DEL. CODE ANN. tit. 8, § 102(b)(7).
[1055] *In re* Baxter Intern., Inc. S'holders Litig., 654 A.2d 1268, 1270 (Del Ch. 1995).
[1056] Wood v. Baum, 953 A.2d 136, 141 (Del. 2008) (citing Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch.2003)).

D. Wrongful Refusal

A plaintiff is required to make a demand on the board of directors to litigate a perceived wrongful act unless such demand would be futile. The Delaware Chancery Court identified minimum requirements that a demand should meet as follows:

> To constitute a demand, a communication must specifically state: (i) the identity of the alleged wrongdoers, (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (iii) the legal action the shareholder wants the board to take on the corporation's behalf.[1057]

The court also stated that "ambiguous communications" should be "construed against a finding of a demand."[1058] The burden of proof to show that the communication includes essential elements of a demand rests upon the party asserting that a demand was made.[1059]

A board receiving a demand is entitled to "a reasonable period of time" to investigate and respond to the claim.[1060] There is "no prescribed procedure that a board must follow," however, a board of directors must act on an informed basis in responding to a demand.[1061] After receiving a demand, "the board must investigate the alleged wrongdoing and then decide upon an appropriate course of action."[1062] The board may "accept the demand and prosecute the action, [ ] resolve the grievance internally without resort to litigation, or [ ] refuse the demand."[1063] In

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1057 Yaw v. Talley, 1994 Del. Ch. LEXIS 35, at *22–23 (Del. Ch. Mar. 2, 1994). *See also* Rales v. Blasband, 634 A.2d 927, 935 (Del. 1993) ("A stockholder demand letter [should], at a minimum, notify the directors of the nature of the alleged wrongdoing and the identities of the alleged wrongdoers.").

1058 *Yaw*, 1994 Del. Ch. LEXIS 35, at *24.

1059 *Id.*

1060 BTZ, Inc. v. National Intergroup, Inc., 1993 Del. Ch. LEXIS 58, at *8 (Del. Ch. Apr. 7, 1993) ("A plaintiff, …, must wait a reasonable period of time after submitting a demand before filing suit otherwise the suit must be dismissed as being premature."); *see also* Charal Inv. Co. v. Rockefeller, 1995 Del. Ch. LEXIS 132, at *7–8 (Del. Ch. Nov. 7, 1995) (same).

1061 Levine v. Smith, 591 A.2d 194, 214 (Del. 1991). *See also Rales*, 634 A.2d 927, 935. The *Rales* court observed that "[i]n most instances, a factual investigation is appropriate so that the board can be fully informed about the validity, if any, of the claims of wrongdoing contained in the demand letter." *Id.* at 935 n.11. The court described the process a board should follow after receiving a demand as follows:

> The task of a board of directors in responding to a stockholder demand letter is a two-step process. First, the directors must determine the best method to inform themselves of the facts relating to the alleged wrongdoing and the considerations, both legal and financial, bearing on a response to the demand. If a factual investigation is required, it must be conducted reasonably and in good faith. Second, the board must weigh the alternatives available to it, including the advisability of implementing internal corrective action and commencing legal proceedings.

Id. at 935. The court noted, however, "a formal investigation will not always be necessary because the directors may already have sufficient information regarding the subject of the demand to make a decision in response to it." *Id.* at 935 n.11.

1062 Piven v. Ryan, 2006 U.S. Dist. LEXIS 12745, at *7 (N.D. Ill. Mar. 23, 2006).

1063 *Rales*, 634 A.2d at 935 (quoting Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 941 (3d Cir. 1982), *vacated and remanded on other grounds,* 465 U.S. 1001 (1984)).

responding to a demand, a board "must affirmatively object to or support the continuation of the [derivative] litigation."[1064]

A board of directors is free to accept or refuse a demand "within the boundaries of their fiduciary duties."[1065] Where a demand was made and refused, the board's decision will be upheld unless it was wrongful. The propriety of a demand refusal is subject to judicial review under the deferential business judgment rule.[1066] As the Delaware Supreme Court stated, a board's refusal "is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption."[1067] Where a board's refusal to sue is protected under the business judgment rule, "the stockholders' ability to initiate a derivative suit is terminated."[1068]

It does not suffice for a plaintiff to merely state that the board's refusal was wrongful. Rather, a plaintiff must raise a reasonable doubt, by alleging particularized facts, that the refusal was the product of a valid exercise of business judgment. Indeed, by making a pre-suit demand, a plaintiff waives his right to contest the independence and disinterestedness of a majority of the board.[1069] Accordingly, "when a board refuses a demand, the only issues to be examined are the

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[1064] Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. 1990) (quoting Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 731 (Del. 1988)).

[1065] Lund, *supra* note 962, at 704.

[1066] *See, e.g.,* Zapata v. Maldonado Corp., 430 A.2d 779, 784 n.10 (Del. 1981) ("[W]hen stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met."); Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984). *See also In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963 (Del Ch. 2007), in which the Chancery Court observed as follows:

> A board may in good faith refuse a shareholder demand to begin litigation even if there is substantial basis to conclude that the lawsuit would eventually be successful on the merits. It is within the bounds of business judgment to conclude that a lawsuit, even if legitimate, would be excessively costly to the corporation or harm its long-term strategic interests. It is not enough for a shareholder merely to plead facts sufficient to raise an inference that the board of directors *would* refuse a demand. A court should not intervene unless that shareholder raises the more troubling inference that the refusal itself would not be a good faith exercise of business judgment.

Id. at 986 (emphasis in original).

[1067] Grimes v. Donald, 673 A.2d 1207, 1219 (Del. 1996) (footnote omitted).

[1068] *Spiegel*, 571 A.2d at 775 (citation omitted).

[1069] *See Levine*, 591 A.2d at 197–98 ("We reaffirm the rule that on a Court of Chancery Rule 23.1 motion to dismiss a derivative suit in a case of demand refused, director independence and lack of self-interest is conceded.); *Grimes*, 673 A.2d 1219 ("[The] plaintiff, by making a demand, waived his right to contest the independence of the board.") By making a demand, a plaintiff also waives his right to claim demand futility.); *Spiegel,* 571 A.2d at 775 ("By making a demand, a stockholder tacitly acknowledges the absence of facts to support a finding of futility….Thus, when a demand is made, the question of whether demand was excused is moot.").

good faith and reasonableness of its investigation."[1070] In reviewing a demand refusal, a court will only examine "whether the directors acted in an informed manner and with due care, in a good faith belief that their action was in the best interest of the corporation."[1071] A court will uphold a board refusal and dismiss the complaint if the plaintiff fails to carry this heavy burden.

In *Grimes v. Donald*, however, the Delaware Supreme Court stated that "if there is reason to doubt that the board acted independently or with due care in responding to the demand, the stockholder may have the basis *ex post* to claim wrongful refusal."[1072] The court reaffirmed this holding in *Scattered* and stated that a demand does not concede "independence 'conclusively' and *in futuro* for all purposes relevant to the demand."[1073] The court explained that "a board that appears independent *ex ante* may not necessarily act independently *ex post* in rejecting a demand."[1074] The court further explained that this proposition is completely consistent with the court's prior holding that the only issues to be examined in a demand refused case are "good faith and the reasonableness of the investigation" because a failure of a board or a committee to act independently when conducting an investigation is "a failure to carry out its fiduciary duties in good faith or to conduct a reasonable investigation."[1075] Accordingly, a "[f]ailure of an otherwise independent-appearing board or committee to act independently" in investigating the claims raised in a demand may constitute wrongful refusal.[1076] One commentator explained this point as follows:

> [W]hile *Grimes* and *Scattered* do not preclude the possibility that a disinterested and independent board might subsequently take some action showing that it did not in fact 'act[ ] independently' in responding to a demand, that must be an '*ex post*' determination—i.e., a determination "[b]ased on knowledge and fact; viewed after the fact, in hindsight.' *Grimes* and *Scattered* do not permit a shareholder who makes a demand, thereby conceding disinterestedness and independence and that the board is capable of acting on the demand, to allege that a board did not 'act[ ] independently' in responding to the demand for reasons having nothing to do with 'act' of refusing the demand and that would have excused the demand '*ex ante*' if true.[1077]

[1070] *Levine*, 591 A.2d at 212 (quoting *Spiegel*, 571 A.2d at 777).
[1071] *Id.* at 198. Where an investigation committee is appointed to investigate the facts underlying the demand and to make a recommendation to an executive committee that has decision-making authority, "particularized allegations that the Special Committee (as the investigating committee) or the Executive Committee (as the decisionmaking committee) was biased, lacked independence, or failed to conduct a reasonable investigation, such allegations could have created a reasonable doubt that demand was properly refused." Scattered Corp. v. Chi. Stock Exch., Inc., 701 A.2d 70, 75 (Del. 1997).
[1072] 673 A.2d 1207, 1219 (Del. 1996) ("The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, *ex ante,* if demand had been excused as futile.").
[1073] *Scattered*, 701 A.2d at 74–75.
[1074] *Id.* at 75.
[1075] *Id*.
[1076] *Id*.
[1077] 4 RADIN, *supra* note 161, at 4494 (citations and footnotes omitted).

Judicial inquiry into the propriety of a demand refusal is solely based on well-pleaded allegations of a complaint. The plaintiff is not entitled to discovery in a demand refused case.[1078] In *Levine*, the plaintiff argued that the burden of proof should fall upon the defendant directors to demonstrate that refusal was not wrongful because the directors have "'better access to the relevant facts' and having raised the defense, the board should have 'the burden of proving that defense.'"[1079] The Delaware Supreme Court rejected this argument and reaffirmed that the plaintiff bears the burden to raise a reasonable doubt that the board's refusal was not protected by the business judgment rule.[1080] Similarly, in *Scattered*, the plaintiffs requested limited discovery because "the Executive Committee has denied them access to books, records and any other documents that would provide information on the reasons why demand was refused."[1081] The Delaware Supreme Court rejected this argument and stated that the plaintiff could have used "the 'tools at hand' to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused."[1082] The court specifically noted the availability of Section 220 of the Delaware General Corporation Law[1083] for the plaintiffs to obtain information regarding the subject of their request.[1084] Because the plaintiff failed to take advantage of section 220, the court rejected the plaintiff's request for limited discovery.[1085] Thus, as the *Scattered* court put it, "[t]he law in Delaware is settled that plaintiffs in a derivative suit are not entitled to discovery to assist their compliance with the particularized pleading requirement of Rule 23.1 in a case of demand refusal."[1086]

The heightened pleading requirements and the business judgment rule presumption put a heavy burden on a plaintiff in a demand refused case. When a plaintiff makes a demand on the board of directors, the plaintiff practically "places the control of the derivative litigation in the

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1078 *See, e.g., Levine*, 591 A.2d at 210; *Scattered*, 701 A.2d at 77.
1079 *Levine*, 591 A.2d at 209.
1080 *Id*. at 210 ("To hold as [the plaintiff] suggests would be a complete abrogation of the principles underlying the pleading requirements of Rule 23.1.").
1081 *Scattered*, 701 A.2d at 77–78.
1082 *Id*. at 78 (quoting *Grimes*, 673 A.2d at 1218).
1083 DEL. CODE ANN. tit. 8, § 220.
1084 *Scattered*, 701 A.2d at 78. *See also* Grimes v. DSC Commc'ns. Corp., 724 A.2d 561, 569 (Del. Ch. 1998) (granting the plaintiff access to the books and records under section 220 in order to obtain information regarding the demand refusal).
1085 *Scattered*, 701 A.2d at 79.
1086 *Id*. at 77.

hands of the board of directors."[1087] A demand refusal is protected under the business judgment rule as long as it is a product of a good faith and informed investigation. In other words, such a demand refusal will be upheld unless it constitutes waste. This is parallel and completely consistent with the effect of the business judgment rule as applied to the case on the merits: the plaintiff has to prove that the demand refusal constitutes waste. Accordingly, if the board of directors rejects the demand, the plaintiff has little chance to continue with the derivative litigation. As one commentator noted, "[t]he general consensus is that it is almost impossible for shareholder plaintiffs to prevail in a 'wrongful refusal' action."[1088]

E. Special Litigation Committees

Even in a case where the demand is excused, a corporation has an opportunity to oppose or control a derivative suit through a Special Litigation Committee (SLC) consisting of disinterested and independent directors who are empowered with the full authority to investigate the derivative claims and to determine whether the litigation is in the best interests of the corporation.[1089] In a demand excused case,[1090] a board of directors may form an SLC and

[1087] *Levine*, 591 A.2d at 209 (quoting *Spiegel*, 571 A.2d at 773–76).
[1088] Lund, *supra* note 962, at 712 n.44.
[1089] *See* Zapata v. Maldonado, 430 A.2d 779, 785–87 (Del. 1981). A board of directors which appoints an SCL is bound by the decision of the committee since full authority with respect to the derivative suit is delegated to the committee. The board of directors may not alter or reject the SCL's decision. The Delaware Supreme Court in *Zapata* held that an authorized and independent board committee possesses the corporate power to seek termination of derivative litigation. The court observed as follows:

> …When, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed? As noted above, a board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful. If the board determines that a suit would be detrimental to the company, the board's determination prevails. Even when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests. Our inquiry is whether, under such circumstances, there is a permissible procedure under § 141(a) by which a corporation can rid itself of detrimental litigation. If there is not, a single stockholder in an extreme case might control the destiny of the entire corporation…. 'To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders.'
>
> …[I]t must be clear that an independent committee possesses the corporate power to seek the termination of a derivative suit. Section 141(c) allows a board to delegate all of its authority to a committee. Accordingly, a committee with properly delegated authority would have the power to move for dismissal or summary judgment if the entire board did.

Id. at 785 (citation omitted). The *Zapata* court also stated that a "board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of … disinterested directors." *Id*. at 786. The court observed:

> We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.

delegate its authority to the committee to decide whether or not the continuation of the derivative suit is in the best interests of the corporation and to act accordingly. The decision of an SLC is binding upon the corporation. After conducting a reasonable investigation in good faith and in an independent manner, the SLC may take control of the litigation (the corporation pursues claims), settle the suit with the plaintiff, or move to dismiss the litigation if it concludes that the continuation of the litigation is not in the best interests of the corporation. The use of an SLC may be advantageous for a board, particularly if its majority is interested in the challenged transaction. In *Beam v. Stewart*, the Delaware Supreme Court observed regarding SLCs as follows:

> An SLC is a unique creature that was introduced into Delaware law by *Zapata v. Maldonado* in 1981. The SLC procedure is a method sometimes employed where presuit demand has already been excused and the SLC is vested with the full power of the board to conduct an extensive investigation into the merits of the corporate claim with a view toward determining whether—in the SLC's business judgment—the corporate claim should be pursued. Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—'above reproach.' Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.

Id. If the full board lacks the disinterestedness or independence to evaluate a demand, the board by resolution may increase the number of directors and then appoint new directors to fill new directorships. The board may then appoint the new disinterested and independent directors as the SLC by delegating its full authority to make an impartial decision with respect to the continuation of the derivative suit based on the best interests of the corporation.

[1090] The use of an SLC is not limited to situations where a plaintiff brings a derivative action without making a demand by claiming that it would be futile. A board which receives a demand may also appoint an SCL with full authority with respect to derivative litigation. In this case, the timing of the formation of the SCL has important consequences. In Abbey v. Computer & Commc'ns. Technology Corp., 457 A.2d 368 (Del Ch. 1983) the plaintiff made a demand on the board of directors and then brought a derivative action claiming that the board did not respond to the demand in a reasonable time. *Id*. at 370. After the commencement of the suit, the board of directors held a meeting to discuss the demand and decided to appoint an SCL to consider the demand. *Id.* at 371. The corporation filed a motion to dismiss the derivative action by claiming that the demand is not excused and the board was not allowed a reasonable time to respond to the demand. *Id*. The plaintiff argued that the formation of the SLC demonstrated that the demand was futile. *Id.* at 372. The court held that by appointing an SLC before filing the motion to dismiss pursuant to Rule 23.1 the board conceded its disqualification and, therefore, its right to claim that the demand was not excused. *Id.* at 374. The court thus denied the motion to dismiss the derivative action pursuant to Rule 23.1. *Id.* In Spiegel v. Buntrock, 571 A.2d 767 (Del. 1990), the Delaware Supreme Court clarified that, if a board files a motion to dismiss before appointing an SLC, the board has not conceded its ability to make an objective evaluation with respect the demand and, therefore, the demand is not excused. *Id.* at 77. Accordingly, where a demand has been made, the board must move to dismiss the derivative action pursuant to Rule 23.1before appointing an SLC in order to preserve the demand required argument. Similarly, where no demand has been made, the board must file a motion to dismiss the suit for failure to make demand before appointing an SLC in order to preserve the demand required argument. It should be also noted that a board is allowed to appoint an SLC even after a motion to dismiss for failure to make a demand has been denied. *See In re* infoUSA, Inc., 2008 Del. Ch. LEXIS 33, at *8 (Del. Ch. Mar. 17, 2008)("The SLC appears to have been properly formed, and the fact that it was formed after demand was excused does not render its formation 'too late.'"). Thus, "there is no rule requiring a corporation to choose between a motion seeking to require a demand and a motion seeking to terminate the case based on a special litigation committee determination." 4 RADIN, *supra* note 161, at 4659 (footnote omitted).

….[B]ecause the members of an SLC are vested with enormous power to seek dismissal of a derivative suit brought against their director-colleagues in a setting where presuit demand is already excused, the Court of Chancery must exercise careful oversight of the bona fides of the SLC and its process.[1091]

If an SLC concludes, after conducting a thorough and objective investigation in good faith, that proceeding with the derivative action is not in the corporation's best interest, the committee should file a motion to dismiss the action.[1092] The Delaware Supreme Court articulated the standard for reviewing an SLC's decision to seek the termination or settlement of a derivative suit in *Zapata*. The court first noted that application of the business judgment rule in this context is not proper because the inherent risks in this type of situation "justify caution beyond adherence to the theory of business judgment."[1093] The court also stated that at this stage of the litigation "some tribute must be paid to the fact that the lawsuit was properly initiated."[1094] The court raised concern that the directors who serve on an SLC pass judgment on fellow directors in the same corporation, and "[t]he question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role."[1095] In light of these considerations, the court articulated a two-step process as follows:

> First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.
> The second step provides, …, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as

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[1091] 845 A.2d 1050, 1055 (Del. 2004) (citations omitted). *See also* Grime v. Donald, 673 A.2d 1207, 1216 n.13. In *Grime,* the court noted the distinction between an investigation committee and an SLC. An investigation committee is formed to assist and advise a board in responding a demand. In contrast, an SLC is vested with the full authority of the board to determine whether the derivative litigation is in the best interests of the corporation. The role of an SLC is not advisory, rather; it is empowered with managerial authority to control the derivative litigation. The *Grime* court noted as follows:

> The use of a committee of the board formed to respond to a demand or to advise the board on its duty in responding to a demand is not the same as the SLC process contemplated by *Zapata,* however. It is important that these discrete and quite different processes not be confused.

Id.

[1092] *Zapata*, 430 A.2d 779, at 788.

[1093] *Id.* at 787.

[1094] *Id.*

[1095] *Id.*

> expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.
>
> If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion…[1096]

Thus, an SLC's judgment to terminate a derivative suit is not entitled to business judgment rule protection. First, the burden is on the corporation to prove that the SLC members acted in good faith and in an independent manner and conducted a reasonable investigation. The corporation should present to the court "a thorough written record of the investigation and its findings and recommendations."[1097] The plaintiff is not bound by the stringent pleading requirements in challenging an SLC's decision, rather; she is entitled to limited discovery. Moreover, courts closely scrutinize the independence of SLC directors in reviewing their decision to terminate the derivative suit.[1098] Even when the corporation satisfies the first test, the merits of an SLC's decision, at the court's discretion, are subject to close judicial scrutiny.[1099] A

[1096] *Id*. at 788–89.
[1097] *Id.* at 788.
[1098] *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003) (finding that the SLC directors lack independence). *See* Holland, *supra* note 10, at 684. As Justice Holland summarized:

> The Oracle special litigation committee consisted of only two members, both of whom were professors at Stanford University. The derivative action was brought against 'another Stanford professor with professional ties to one of the committee members, a Stanford alumnus who had directed millions of dollars in contributions to Stanford and served on a Stanford advisory board with one of the committee members, and Larry Ellison, the CEO, who had donated millions of dollars to Stanford.'

Id. (citation omitted). The *Oracle* court concluded that the SLC failed to satisfy the test for independence:

> It is no easy task to decide whether to accuse a fellow director of insider trading. For Oracle to compound that difficulty by requiring SLC members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law was unnecessary and inconsistent with the concept of independence recognized by our law. The possibility that these extraneous considerations biased the inquiry of the SLC is too substantial for this court to ignore. I therefore deny the SLC's motion to terminate.

Oracle, 824 A.2d at 921.
[1099] *But see* Carlton Invs. v. TLC Beatrice Int'l Holdings, 1997 Del. Ch. LEXIS 86, at *7–8 (Del. Ch. May 30, 1997). In this case, former Chancellor Allen criticized the second step of the *Zapata* test as follows:

> As to the conceptually difficult second step of the *Zapata* technique, it is difficult to rationalize in principle; but it must have been designed to offer protection for cases in which, while the court

court may apply its own independent business judgment to determine whether the SLC's decision is in the best interests of the corporation. The unique nature of SLCs requires a departure from the deferential business judgment rule in order to protect the interests of a corporation.[1100]

> could not consciously determine on the first leg of the analysis that there was no want of independence or good faith, it nevertheless 'felt' that the result reached was 'irrational' or 'egregious' or some other such extreme word. My opinion is that courts should not make such judgments but for reasons of legitimacy and for reasons of shareholder welfare.

Id.

[1100] The Delaware Chancery Court in several decisions questioned the efficiency of the SLC procedure in derivative litigation. *See, e.g.,* Kaplan v. Wyatt, 484 A.2d 501, 509–10 (Del. 1984) ("[The SLC procedure] is fraught with practical complications at the trial court level. It certainly does not speed up the course of derivative litigation and, …, it is doubtful that it reduces the expense or inconvenience of derivative litigation to the corporation."); Sutherland v. Sutherland, 2008 Del. Ch. LEXIS 24, at *9 (Del. Ch. Feb. 14, 2008) (describing the SLC procedure "as inefficient due to its tendency to create 'litigation within litigation'") (quoting *Kaplan*, 484 A.2d at 510–12).

CHAPTER VI. A PROPOSAL TO STRIKE A BALANCE ON DUE CARE LIABILITY OF DIRECTORS IN DELAWARE

The cardinal precept of corporate law is that the authority to manage the business and affairs of a corporation belongs to its board of directors.[1101] In the modern world, a board of directors does not actively participate in daily operation of a corporation's business. A board of directors hires executive officers, and the executive officers take care of direct, hands-on management of the business and affairs of the corporation. Retaining the ultimate authority and responsibility,[1102] a board of directors delegates many of its managerial responsibilities to the board committees and to the corporation's executive officers. In modern corporations, a board of directors primarily functions as a control mechanism over the management of a corporation's business and affairs. A modern corporate board's managerial role entails two main functions: decision-making and oversight. As explained in the Corporate Director's Guidebook:

> The board's decisionmaking function generally involves considering and, if warranted, approving corporate policy and strategic goals and taking specific actions such as evaluating and selecting top management, approving major expenditures and transactions and acquiring and disposing of material assets. The board's oversight function involves monitoring the corporation's business and affairs including, for example, financial performance, management performance, compliance with legal obligations and corporate policies, and evaluating and designing appropriate risk management structures.[1103]

Thus, directors do not actively manage the business and affairs of a corporation; rather, they manage the direction of a corporation.

Because directors manage the direction of a corporation for the benefit of its shareholders, they are subject to the fiduciary duties imposed by the common law.[1104] Directors are elected by shareholders to maximize the value of shareholders' investments in corporations.[1105] Therefore, "[t]he existence and exercise of [directors' statutory] power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders."[1106] The

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[1101] DEL. CODE ANN. tit. 8, § 141(a) (2011); *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").
[1102] *See* Paramount Commc'ns v. QVC Network, 637 A.2d 34, 43 (Del. 1994) (citing Mills Acquisition Co. v. Macmillan, Inc., 559 A. 2d 1261, 1280 (Del. 1988)).
[1103] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 11.
[1104] *See supra* Chapter II.C.1. (explaining the fiduciary status of corporate directors).
[1105] *See* CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 11 ("Directors have a responsibility to act in the best interests of the corporation and its shareholders. To do so, they must focus on maximizing the value of the corporation for the benefit of its shareholders.").
[1106] *Aronson*, 473 A.2d at 811.

fiduciary duties are in place to assure that directors act in accordance with the purpose for which they are elected. Directors must act in the best interests of the corporation and its shareholders when exercising their statutory authority, and they must discharge their managerial responsibilities accordingly.

Traditionally, directors' fiduciary duties are divided into two categories: loyalty and care. Almost three centuries ago, the Lord Chancellor of England recognized the fiduciary duties of loyalty and care by stating that directors of a corporation must act with "fidelity and reasonable diligence."[1107] The duty of loyalty requires directors to subordinate their self-interest (or a related person's or institution's interest) to the interest of the corporation when these two conflict.[1108] Directors must refrain from using their position to advance their personal betterment at the expense of the corporation and its shareholders. The duty of loyalty encompasses the obligation to act in good faith as well.[1109] Good faith requires an honest exercise of managerial powers to advance the best interests of the corporation and its shareholders.[1110] Good faith encompasses "all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."[1111] The duty of care describes the manner in which directors must perform board service.[1112] It requires directors to discharge their managerial responsibilities diligently, attentively, and on an informed basis.[1113] Directors must pay an informed attention to corporate matters when performing their decision-making and oversight functions.

Although the duties of loyalty and care are two different concepts, they are both designed to ensure that directors exercise their managerial power in a manner that is consistent with the

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[1107] Charitable Corp. v. Sutton, (1742) 26 Eng. Rep. 642, 645 (Ch.).
[1108] *See supra* Chapter IV.A.1., 2. (examining the duty of loyalty and its historical progress in Delaware).
[1109] *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (holding that the duty of loyalty "encompasses cases where the fiduciary fails to act in good faith).
[1110] *See supra* Chapter IV.B.1.a., 2. (examining the scope of good faith).
[1111] *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005).
[1112] *See supra* Chapter III.B.1.a., b. (examining the standard of care and the historical progress of duty of care law in Delaware).
[1113] Generally, directors may discharge their due care responsibilities by "attending meetings, reading materials and otherwise preparing in advance of meetings, asking questions of management or advisors, requesting legal or other expert advice when desirable for a board decision, and bringing the director's own knowledge and experience to bear." CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 19. In order to comply with the duty of care, a board meeting "should be informative and should encourage the free exchange of ideas so that a corporation's directors—through their active, meaningful participation—may keep themselves fully informed." Fogel v. U.S. Energy Sys., 2007 Del. Ch. LEXIS 178, at *9 (Del. Ch. Dec. 13, 2007). The duty of care encompasses the directors' oversight function as well. In order to comply with the duty of care in the oversight context, directors should inform themselves of corporate business and affairs by installing appropriate monitoring and reporting systems, and take appropriate steps when necessary. *See In re* Caremark Int'l Inc. Derivative Litig, 698 A.2d 959, 969–70 (Del. Ch.1996).

best interests of the corporation.[1114] One commentator explained the fiduciary duties of loyalty and care and how they relate to one another as follows:

> The duty of loyalty defines *what* the directors are to seek to accomplish—i.e., the best interests of the corporation. The duty of care defines *how* they are to pursue that goal—i.e., by [making informed decisions.] Good faith, on the other hand, describes the state of mind of a director who is acting in accordance with her duty of loyalty. The duty of loyalty requires that a director's corporate decision be based on a good-faith *belief* that it will serve the best interests of the corporation. It is the absence of that belief that justifies imposing personal liability upon a director.[1115]

He exemplified the interaction between the duties of loyalty and care in the decision-making context as follows:

> The directors' belief that a decision will benefit the corporation is developed by gathering information relevant to the decision at hand. This process implicates the duty of care. Care and loyalty relate to one another as do means and ends. Loyalty defines the end to be served by the decision—the best interests of the corporation or its stockholders. Care is the means by which the decision is made. "Good faith" is the state of mind, the belief, that animates the decision.[1116]

Thus, the duties of loyalty and care are related to each other in a broader sense, and they are equally important in order to protect the interests of a corporation and its shareholders. Conduct required under the duties of loyalty and care is pivotal for ensuring the proper exercise of managerial powers bestowed upon corporate directors by statutes.

The duty of care, however, raises certain policy concerns in the corporate context. The risky nature of business and the special characteristics of board service call courts' ability to measure directors' due care compliance into question.[1117] Directors deal with complex business

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[1114] *See Disney,* 907 A.2d 693, 746 n.402. ("Perhaps these categories of care and loyalty, so rigidly defined and categorized in Delaware for many years, are really just different ways of analyzing the same issue.").

[1115] Furlow, *supra* note 450, at 1063 (emphasis in original) (footnotes omitted).

[1116] *Id.* at 1070.

[1117] *See supra* Chapter III.C.3. (examining the rationale supporting the business judgment rule); *see also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion,* 48 LAW & CONTEMP. PROBS. 83, 108–09 (1985). The authors nicely explain the potential problems that may arise from judicial review of risky business decisions as follows:

> The [directors'] role includes risk seeking, mindful that the greater returns lie with opportunities having the greater risk. The linkage between risk and return offers the most compelling justification for judicial deference to managerial decisions. It is argued that an overly intrusive judicial approach would discourage legitimate and necessary entrepreneurial risk taking. Judicial intrusion creates a fear that decisions resulting in corporate losses will subject corporate managers to liability. This fear is heightened by the volatility of the business environment and the frequent need for corporate decisions to be made on the basis of incomplete or imperfect information. Moreover, even though theoretically the circumstances under which a decision is rendered should be considered in judging whether the directors were negligent, the crispness with which a trier of fact will understand those circumstances as they *then* existed, as contrasted with how they are reconstructed with the benefit of hindsight, interjects a pernicious dimension into any activism on the court's part. Further supporting this deference to the directors' business judgments is the view

matters, and they often make risky business decisions on the basis of incomplete and imperfect information under unique circumstances. When a business decision results in a bad outcome to the corporation, it is difficult to determine with a hindsight review whether directors exercised appropriate care in making the decision. In other words, it is difficult to determine whether the bad outcome is a result of directors' failure to exercise due care or whether it is merely a realization of the risk inherent in the nature of business. If courts enforce the duty of care strictly and hold directors responsible for corporate losses, those who serve on corporate boards would tend to be risk-averse and exercise excessive care to avoid personal liability. This, in turn, would contradict the policy that seeks to promote corporate risk-taking. Risk is an essential element of business success, and the law should not discourage directors from making risky decisions in the pursuit of maximizing the value of corporations.

Furthermore, the magnitude of potential liability for a breach of the duty of care may deter competent people from serving on corporate boards. Directors often make large-scale business decisions, and the loss resulting from an unsuccessful business decision may well be in excess of millions of dollars. Directors are personally liable for the entire amount of damages suffered by the corporation as a result of a breach of the duty of care. A strict enforcement of the duty of care may expose directors to catastrophic personal liability for their honest mistakes. Draconian monetary liability may often be disproportionate to the wrongful conduct. At the very least, this would cause reluctance among competent individuals to serve on corporate boards. Considering the modest directorship fees, competent individuals would avoid risking their life-time savings for a small return by serving on corporate boards. Moreover, those who serve on corporate boards would naturally be overcautious and risk-averse to avoid personal liability.

Over the years, courts developed the business judgment rule to facilitate corporate risk-taking by freeing directors from the fear of personal liability.[1118] The business judgment rule "is

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> that directors are, at least in the normative view, selected because of their experience in, knowledge of, or sensitivity to production, finance, or the marketplace. These are not entry level qualifications to the judiciary.

Id. (emphasis in original) (footnotes omitted).

[1118] *See supra* Chapter III.C.1 (examining the development of the business judgment rule in Delaware). Professor Hecker nicely explained the rationale supporting the business judgment rule as follows:

> Business necessarily involves risk, and risk and potential profit are directly related. Over time, riskier decisions produce greater profit, even after factoring in losses, than do more conservative decisions. The business judgment rule recognizes this and attempts to free directors from the fear of personal liability if a decision that appeared to be a reasonable risk at the time turns out badly.

the foundation of [Delaware] corporation law."[1119] It is judicial recognition of the cardinal statutory corporate norm that the authority to manage the business and affairs of a corporation is bestowed upon its board of directors.[1120] It "exists to protect and promote the full and free exercise of" the directorial powers.[1121] The business judgment rule upholds the directors' managerial authority in a court room by defining the limits of judicial inquiry into fiduciary behavior in the decision-making context. As one commentator nicely summarized:

> In Delaware in particular, the skilled application of the rule allows the courts to police ridiculous behavior while shielding unreasonable, but not irrational, behavior. The rule allows courts to balance proper entrepreneurial risk-taking against aberrant behavior that has no accountability. The ancient theory of the rule is sound—business is most likely to prosper when managers are free to make decisions unencumbered by judicial second-guessing regarding the wisdom of their choices.[1122]

The rule operates as 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."[1123] Where a business decision meets the prerequisites of the business judgment rule, it immunizes the substantive merits of a business decision from judicial review and protects directors from liability even though the decision results in a loss to the corporation. In *Brehm v. Eisner*, the Delaware Supreme Court provided a succinct statement of the business judgment rule as follows:

> [Under the business judgment rule] directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.[1124]

The implications of the business judgment rule are of paramount significance in the duty of care context. In the decision-making context, "[t]he duty of the directors of a company to act

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> A contrary rule that imposed liability on the basis of ordinary negligence, or even gross negligence, with respect to the *substance* of a decision would create an incentive for directors to pursue the least risky, most conservative of the options available to them, to the disadvantage of their shareholders generally.

Hecker, *supra* note 26, at 937 (emphasis in original) (footnote omitted).

1119 Veasey & Di Guglielmo, *supra* note 742, at 1442.

1120 *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 *Del.C.* § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.").

1121 *Id.*

1122 Bishop, *supra* note 807, at 920 (footnotes omitted).

1123 *Aronson,* 473 A.2d at 812.

1124 746 A.2d 244, 264 n.66 (Del. 2000).

on an informed basis, … , forms the duty of care element of the business judgment rule."[1125] To be afforded business judgment rule protection, directors must "inform themselves, prior to making a business decision, of all material information reasonably available to them."[1126] Because the business judgment rule presumes that directors make informed decisions, the burden is on the plaintiff to establish facts demonstrating directors' failure to make an informed decision. Further, under the business judgment rule, directors' decision-making process is subject to judicial review under a lenient gross negligence standard, which is less exacting than the typical due care standard of ordinary negligence.

A plaintiff contesting a business decision on the ground of the duty of care assumes the difficult burden to demonstrate that directors reached their decision "by a grossly negligent process that includes the failure to consider all material facts reasonably available."[1127] A grossly negligent decision-making process requires an extreme deficiency in the performance of directorial responsibilities.[1128] If a plaintiff is able to rebut the business judgment rule presumption by showing a grossly negligent decisional process, the burden then shifts to the defendant directors to prove the entire fairness of their decision-making process and the decision resulting from it.[1129] If a plaintiff is unable to overcome the business judgment rule presumption, the challenged decision is subject to judicial review under the onerous waste (irrationality) standard.[1130]

The business judgment rule does not protect a decision that is irrational—not attributable to any rational business purpose.[1131] The waste standard is extremely difficult for a plaintiff to

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1125 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993). Delaware courts "do not measure, weigh or quantify directors' judgments" on the ground of the duty of care. *Brehm,* 746 A.2d at 264. Accordingly, "[d]ue care in the decisionmaking context is *process* due care only." *Id.* (emphasis in original).

1126 *Aronson*, 473 A.2d at 812. Former Justice Quillen nicely explained the informational element of the business judgment rule as follows: "[D]irectors [must] exercise[ ] due care by informing themselves of the pertinent facts necessary to make a decision and by reflecting upon such facts with sufficient deliberation." Quillen, *supra* note 198, at 490.

1127 *Brehm*, 746 A.2d 244 at 264 n.66.

1128 Judicial inquiry under a gross negligence standard involves an objective evaluation of the challenged decision-making process based on the facts of a particular case. *See Brehm*, 746 A.2d at 259. Commentators have raised concerns with respect to the adequacy of an objective test for evaluating the directors' decision-making process. *See supra* Chapter III.E.1. (examining the scholarly response to the *Van Gorkom* holding in which the Delaware Supreme Court found the defendant directors to have breached their duty of care by failing to inform themselves in a grossly negligent manner before approving a major corporate action).

1129 *Cede*, 634 A.2d at 361.

1130 *See supra* Chapter III.C.1.a. (examining waste/irrationality standard).

1131 *Brehm,* 746 A.2d at 264 n.65 ("Directors' business 'decisions will not be disturbed if they can be attributed to any rational business purpose.'") (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

overcome—she must show that a decision is so aberrant that it is explicable only on the basis of bad faith[1132] or that a transaction is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[1133] Thus, under the business judgment rule, directors are afforded considerable protection from personal liability for corporate losses resulting from an unsuccessful business decision.

The business judgment rule, however, "operates only in the context of director action. … [I]t has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."[1134] Where no decision was made, the business judgment rule presumption is unavailable. It does not protect directors' nonfeasance or unconsidered failures to act.[1135] Accordingly, the business judgment rule is not applicable where a plaintiff claims an oversight failure.[1136] Notwithstanding, Delaware courts apply a lenient standard of gross negligence rather than an exacting ordinary negligence for reviewing an alleged oversight failure.[1137] A lenient standard for determining the directors' due care compliance in the oversight context, as it is in the decision-making context, is necessary to encourage qualified individuals to assume directorships without fear of personal liability. Thus, although the business judgment rule is technically not applicable in reviewing the oversight failures, the policy underlying the rule justifies a lenient judicial treatment in addressing this type of claim as well.

[1132] *Id.*
[1133] *Disney*, 906 A.2d at 74.
[1134] *Aronson*, 473 A.2d at 813.
[1135] As the Delaware Chancery Court nicely illustrated:

> Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow *from a board decision* that results in a loss because that decision was ill advised or 'negligent'. Second, liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.

Caremark, 698 A.2d at 967 (emphasis in original). The second category of due care claims typically relates to the directors' oversight failures. These types of claims are often referred to as "classic *Caremark* claims."
[1136] However, as the Delaware Supreme Court noted, "a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule." *Aronson*, 473 A.2d at 813. Accordingly, the directors' "good faith, informed, and disinterested decisions as to the specifics regarding implementation of its oversight functions are subject to the protection of the business judgment rule." Hecker, *supra* note 26, at 938 (footnote omitted).
[1137] *See supra* Chapter III.D. (examining the standard of review in the decision-making context). *See also Disney,* 907 A.2d at 748. ("[I]n instances where directors have not exercised business judgment, that is, in the event of director inaction, the protections of the business judgment rule do not apply. Under those circumstances, the appropriate standard for determining liability is widely believed to be gross negligence.") (footnotes omitted).

In addition to protecting directors against merits of a lawsuit, the business judgment rule plays an important role in the pre-trial stage of derivative litigation.[1138] In order to protect the interests of a corporation from malfeasance or nonfeasance of unfaithful directors or officers, equity developed the derivative action to enable shareholders "to enforce a *corporate* cause of action against officers, directors, and third parties."[1139] It is unlikely that directors will pursue a corporate cause of action involving fiduciary claims against themselves or their colleagues. Accordingly, minority shareholders are allowed to bring a derivative action against directors to redress corporate harm resulting from a breach of a fiduciary duty.

Plaintiff-shareholders are subject to the director demand requirement to bring a derivative action. Under the director demand requirement, a plaintiff must either make a pre-suit demand on the board of directors to litigate the perceived wrongdoing or demonstrate that such demand would be futile and, therefore, should be excused. Where a demand has been made refused, the refusal is subject to judicial review under the deferential business judgment rule. Where a plaintiff claims demand excusal, she must plead particularized facts creating a reasonable doubt that the defendant directors are sufficiently independent to impartially evaluate the demand,[1140] or that the challenged decision is otherwise entitled to business judgment rule protection. Thus, the business judgment rule puts a heavy burden on a plaintiff at the pleading stage of a derivative action. In order to proceed to discovery and the merits of a derivative complaint, a plaintiff must plead particularized facts creating a reasonable doubt as to the availability of the business judgment rule presumption that directors are faithful to their fiduciary duties.[1141]

Although the business judgment rule arguably provides directors considerable protection from personal liability, the Delaware Supreme Court's holding in the landmark case of *Smith v. Van Gorkom*[1142] created serious concern that it was not as protective as predicted. In *Van Gorkom*, the court found the defendant directors to have lost the protection of the business

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[1138] *See supra* Chapter V. (examining derivative litigation).

[1139] Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) (quoting Ross v. Bernhard, 396 U.S. 531, 534 (1970)) (emphasis in original).

[1140] If a plaintiff challenges a business decision, she may challenge the directors' independence to evaluate a demand by creating a reasonable doubt that either the majority of the board is disinterested in the decision or the majority of the board is free from domination or control by the interested party. In the oversight context, a plaintiff may create a reasonable doubt that the directors are impartial and independent by pleading with particularity facts indicating that the majority of the board faces a substantial likelihood of liability. For a detailed examination of demand excusal *see supra* Chapter V.C.

[1141] Beam v. Stewart, 845 A.2d 1040, 1048–49 (Del. 2004).

[1142] 488 A.2d 858 (Del. 1985).

judgment rule for failing to inform themselves in a grossly negligent process before approving a cash-out merger.[1143] In so holding, the court exposed the defendant directors to potentially catastrophic personal liability even though self-dealing, fraud, waste, or bad faith was not at issue in the case. The court's holding shocked the corporate world. It sparked "vociferous commentary and harsh criticism."[1144] After *Van Gorkom*, the fear of personal liability reached its peak among corporate directors.[1145] Director liability insurance premiums skyrocketed, and many qualified individuals refused to serve on corporate boards. Therefore, the prevailing perception in corporate America after *Van Gorkom* was that "[t]he Delaware business judgment rule had been inadequate to protect the directors, placing the future of directors, and therefore corporate governance, in serious doubt."[1146]

The Delaware legislature swiftly responded to the corporate crisis caused by *Van Gorkom* by adding section 102(b)(7) to its General Corporation Law.[1147] Essentially, this section allows a corporation to exonerate its directors from personal monetary liability for a breach of the duty of care through a charter provision. As the Delaware Supreme court explained it:

> The purpose of Section 102(b)(7) was to *permit shareholders*—who are entitled to rely upon directors to discharge their fiduciary duties at all times—to adopt a provision in the certificate of incorporation to exculpate directors from any personal liability for the payment of monetary damages for breaches of their duty of care, but not for duty of loyalty violations, good faith violations and certain other conduct.[1148]

Other states followed Delaware's lead and enacted similar permissive laws. The overwhelming majority of corporations quickly took advantage of the permissive statutes and amended their certificates of incorporation to adopt such provisions. Therefore, "while exculpatory provisions are not a statutory default rule, they operate like one in practice."[1149]

Technically, section 102(b)(7) allows "only limitation or elimination of the damages remedy, not the underlying duty of care itself."[1150] Corporate directors continue to be subject to the duty of care even if a corporate charter includes a section 102(b)(7) provision. Such a provision does not affect the availability of injunctive proceedings based on a breach of the duty

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[1143] *Id.* at 893. For a detailed examination of the *Van Gorkom* case *see supra* Chapter III.E.1.
[1144] Horsey, *supra* note 230, at 972.
[1145] *See supra* Chapter III.E.1 (examining the aftermath of and scholarly response to *Van Gorkom*).
[1146] Bishop, *supra* note 807, at 906.
[1147] DEL. CODE ANN. tit. 8, § 102(b)(7).
[1148] Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (emphasis in original).
[1149] Knees, *supra* note 933, at 218.
[1150] Hecker, *supra* note 26, at 941 n.103; *Disney*, 907 A.2d at 752.

of care.[1151] However, as Professor Hecker observed, "[a]s a practical matter, one would not expect to encounter many cases outside of the mergers and acquisitions context in which a plaintiff sought to enjoin a breach of the duty of care."[1152] Furthermore, injunctive remedies "have only limited applications and thus cannot serve as an adequate substitute for financial liability, in part because due care suits typically arise well after the event."[1153] Therefore, outside the mergers and acquisitions context, injunctive relief may not be an efficient tool for shareholders to enforce the duty of care.

The effect of a section 102(b)(7) provision is as much procedural as it is substantive.[1154] Delaware courts have consistently stated that a section 102(b)(7) provision "bars the recovery of monetary damages from directors for a successful shareholder claim that is based exclusively upon establishing a violation of the duty of care."[1155] In *Malpiede*, the Delaware Supreme Court held that "any claims for money damages against directors that are based solely on alleged breaches of the board's duty of care" are dismissible once the corporation's section 102(b)(7) provision is properly invoked.[1156] A section 102(b)(7) provision "*bars* a claim [for money damages] that is found to state only a due care violation."[1157] Accordingly, a section 102(b)(7) provision not only exempts directors from monetary liability but also prevents a shareholder from litigating a due care violation unless the shareholder seeks injunctive relief. "This, in turn, masks the proper inquiry into whether the duty of care itself has been breached—a question quite separate and distinct from whether liability should attach to that breach."[1158]

The procedural effect of a section 102(b)(7) provision destroys the efficacy of the duty of care. The primary purpose of section 102(b)(7) is to provide directors substantive protection from monetary liability for a duty of care violation; however, its procedural impact goes far beyond that and devastates the viability of a duty of care action. In the absence of an

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[1151] Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001); *Disney*, 907 A.2d at 752.
[1152] Hecker, *supra* note 26, at 941 n.103.
[1153] PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 Rep.'s note 2. (1994).
[1154] Sale, *supra* note 917, at 12 (arguing that the procedural impact of section 102(b)(7) eradicates the duty of care).
[1155] *Emerald Partners*, 787 A.2d at 91.
[1156] *Malpiede*, 780 A.2d at1095 n.71.
[1157] *Id.* at 1095 (emphasis added). *See also Emerald Partners*, 787 A.2d at 92 ("The rationale of *Malpiede* constitutes judicial cognizance of a practical reality: unless there is a violation of the duty of loyalty or the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care.").
[1158] Bishop, *supra* note 807, at 918.

enforcement mechanism, it is hard to believe that the duty of care will play a meaningful role to deter directors from irresponsible decision making or oversight. Although such provisions do not affect the availability of injunctive relief, as a practical matter, plaintiffs rarely seek to enjoin a breach of the duty of care outside the mergers and acquisitions context. Therefore, a section 102(b)(7) provision significantly reduces the ability of shareholders to monitor and discipline noncompliant director behavior through litigation.

Section 102(b)(7) explicitly excludes duty of loyalty violations and "acts or omissions not in good faith" from exculpable conduct.[1159] Accordingly, as the Delaware Supreme Court put it, "in actions against the directors of Delaware corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege well-pled facts that, if true, implicate breaches of loyalty or good faith."[1160] A shareholder can bring a fiduciary claim for money damages against directors for a breach of the classic duty of loyalty (pecuniary conflict of interest) or for a failure to act in good faith. The Delaware Supreme Court provided three examples of conduct that would establish a failure to act in good faith in *Disney*:

> where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[1161]

In *Stone*, the court held that good faith is not an independent, free-standing fiduciary duty; it is rather a subsidiary element of the duty of loyalty.[1162] In so holding, the court expanded the duty of loyalty "beyond its classical financial conflict of interest bounds to include nonpecuniary misconduct not in good faith."[1163] Conduct lacking good faith results in personal liability because it constitutes a breach of duty of loyalty. Thus, after *Stone*, the only actionable fiduciary claim for money damages is a violation of the duty of loyalty, which now includes the obligation of good faith. Where a corporate charter includes a section 102(b)(7) provision, a shareholder complaint for money damages must contain "well-pleaded allegations that the defendant

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[1159] *See* DEL. CODE ANN. tit. 8, § 102(b)(7).
[1160] *Emerald Partners*, 787 A.2d at 92.
[1161] *Disney*, 906 A.2d at 67 (citation omitted). The court also noted that "[t]here may be other examples of bad faith yet to be proven or alleged, but these three are the most salient." *Id.* (citation omitted).
[1162] *Stone*, 911 A.2d at 369–70.
[1163] Hecker, *supra* note 26, at 981.

directors breached their duty of loyalty by engaging in intentional, bad faith, or self-interested conduct."[1164]

In the post-exculpatory world, the concept of good faith is most important with respect to non-self-dealing director decisions, or oversight failures that involve complete abdication of all directorial responsibility.[1165] Under Delaware's new good faith doctrine, "[k]nowing or deliberate indifference by a director to his or her duty to act faithfully and with *appropriate care*"[1166] constitutes non-exculpable bad faith conduct. In other words, an intentional or conscious abdication of directorial responsibilities in corporate decision making or oversight is bad faith conduct, and it is actionable under the duty of loyalty. Directors are subject to personal liability for money damages for such conduct regardless of a section 102(b)(7) provision.

However, the liability bar under the new good faith standard is quite high.[1167] Actionable bad faith conduct not only involves egregious misconduct but also requires a subjective and negative state of mind that is inconsistent with the interests of the corporation. Only a very extreme and unlikely set of facts would constitute non-exculpable bad faith conduct and result in personal liability. Considering the exacting procedural hurdles a plaintiff must overcome to bring a derivative action, the plaintiff has little chance to plead successful non-exculpable derivative claims against disinterested yet inattentive directors.[1168] It is extremely difficult for a plaintiff to

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[1164] McMillan v. Intercargo Corp., 768 A.2d 492, 495 (Del. Ch. 2000).
[1165] Self-dealing director transactions are addressed under the classic duty of loyalty and malicious director decisions are addressed under the classic good faith concept (good faith element of the business judgment rule).
[1166] *Disney*, 906 A.2d at 63 n.97 (emphasis added) (citation omitted).
[1167] *See supra* Chapter IV.B.3 (examining the new good faith doctrine and contending that it is inadequate to address inattentive director conduct).
[1168] *See generally* Knees, *supra* note 933. The author observed as follows:

> Demand, particularized pleadings at the outset of the case, the presumption of the business judgment rule, demand-excuse tests, and the role of an SLC all pose significant procedural obstacles for a shareholder plaintiff bringing a derivative suit for failed oversight. These procedural hurdles, combined with the doctrinal collapse of the three fiduciary duties into a single standard under the duty of loyalty, create a very narrow scope of oversight liability, which serves director authority. The threshold that a plaintiff must surpass in order to rebut the business judgment rule presumption at the outset of the case is heightened by the collapse of the fiduciary duties into a single, actionable standard under the duty of loyalty. In order to rebut the business judgment rule, the shareholder plaintiff must demonstrate a likely breach of a fiduciary duty—which can only be pleaded as a breach of the duty of loyalty in oversight [or disinterested business decision] cases where an exculpatory provision exists. Therefore, the plaintiff must plead with particularity at the outset of its case that a director-defendant acted with either intent to harm the corporation or a conscious disregard of his or her duties, both very high thresholds.

Id. at 233–34 (footnote omitted). She concludes that section 102(b)(7) and its interpretation by Delaware courts created a "toothless tiger"—an eviscerated standard that in practice rarely poses any meaningful threat of liability absent a violation of law. *Id.* at 215–16. *See also* Lund, *supra* note 962, at 393, 407–13 (examining Lyondell challenge directors' good faith without the benefit of discovery.[1169] The demand requirement and the role of the business judgment rule presumption at the outset of derivative litigation practically prevent shareholders from challenging inattentive decision making or oversight under the duty of loyalty.

Section 102(b)(7) and its interpretation by Delaware Courts significantly limit the scope of shareholder derivative lawsuits. The shareholder derivative action is traditionally an important mechanism to enforce and encourage compliant director behavior. However, the combined effect of section 102(b)(7), the demand requirement, recent doctrinal developments, and the business judgment rule significantly narrows the scope of director liability. The doctrinal limitations and procedural obstacles have created an environment in which virtually no oversight or decision-making claims could survive a motion to dismiss.[1170] In the non-self-dealing context, "[p]leading particularized facts establishing a breach of the duty of loyalty at the outset of a case, before discovery, is a significant procedural hurdle for plaintiffs."[1171] The cumulative effect of doctrinal and procedural hurdles "is a de facto 'no liability' rule for [disinterested yet inattentive] corporate directors."[1172]

Thus, a combination of substantive doctrines and procedural requirements dilutes disciplinary power of the derivative lawsuit and undermines director accountability.[1173] A section 102(b)(7) provision virtually eliminates any threat of personal liability for fiduciary misconduct unless it involves "conflicted directors who acted in their own interests or committed fraud or waste."[1174] It is highly doubtful whether a nearly impenetrable shield against personal liability for nonpecuniary misconduct is adequate to assure director engagement to managerial

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Chemical Co. v. Ryan, 970 A.2d 235 (Del. 2009), McPadden v. Sidhu, 964 A.2d 1262 (Del. Ch. 2008), *In re* Lear S'holders Litig., 967 A.2d 640 (Del. Ch. 2008) and concluding that the scope of the conscious disregard standard is very narrow).

[1169] As Knees observed, "demonstrating intent to harm or a conscious disregard of one's duties may require the type of investigation that is best suited for depositions and other forms of traditional discovery." Knees, *supra* note 933, at 228.

[1170] *Id.* at 257.

[1171] *Id.* at 228.

[1172] *See* Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance,* 92 IOWA L. REV. 105, 118 (2006).

[1173] *Id.*

[1174] Elizabeth A. Nowicki, *Director Inattention and Director Protection under Delaware General Corporation Law Section 102(b)(7): A Proposal for Legislative Reform,* 33 DEL. J. CORP. L. 695, 707 (2008); *see also* Jones, *supra* note 1172, at 118 ("Independent directors face an infinitesimal risk of paying personally for damages to the corporation caused by their breach of fiduciary duty. They face no real risk of liability for their acts or omissions as directors.").

responsibilities. "One wonders how a set of virtually unenforceable rules can be expected to influence the actions of corporate officers and directors."[1175] One commentator stated that section 102(b)(7) "encourages an unsound policy allowing directors to be inattentive and careless."[1176] It basically invites directors to manage the direction of a corporation with a warm heart and empty mind.

Elizabeth Nowicki raised concern with respect to the adequacy of the fiduciary liability regime created by section 102(b)(7). She argued that section 102(b)(7) practically eliminates any meaningful threat of monetary liability for inattentive directors, and this is not desirable to induce directors for compliant behavior.[1177] Behavioral psychology research examined in her work is worth considering in evaluating the potential effect of *ex ante* liability protection on director behavior. The study she examined indicates that the threat of punishment plays an important role in motivating actor behavior. According to the study, "the threat of punishment, *or even just the awareness of having one's behavior monitored*, can motivate improved task performance, increased attention, and appropriate or responsible behavior."[1178] The study also illustrates that "actors who face a credible threat of punishment for the failure to perform well or *who know they are monitored* perform better than those who face no threat of punishment or who do not believe they are being observed."[1179] Accordingly, behavioral research suggests that "the threat of punishment by way of legal liability should be useful in addressing director inattention and boardroom lethargy."[1180] The existence of some credible threat of personal liability is necessary to assure director engagement or attentiveness. Nowicki concluded that section 102(b)(7) does not serve this end, and, therefore, it should be revised.[1181]

It is also worth considering behavioral psychology research concerning ingroup bias to evaluate the potential effect of a section 102(b)(7) provision on director behavior. In general, ingroup bias is the "tendency to evaluate one's own groups more positively in relation to other

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[1175] Jones, *supra* note 1172, at 108.
[1176] Blank, *supra* note 696, at 122 (citation omitted).
[1177] *See generally* Nowicki, *supra* note 1174; *see also* Jones, *supra* note 1172, at 111(stating "that the existing liability regime for fiduciary duties fails as an accountability mechanism").
[1178] Nowicki, *supra* note 1174, at 706 (emphasis added).
[1179] *Id*. at 697 (emphasis added).
[1180] *Id*. at 706.
[1181] *See infra* notes 1206–10 & accompanying text.

groups."[1182] This may result in preferential treatment among group members.[1183] In the corporate context, this may cause directors to favor their board colleagues or the corporation's executive officers. Commentators have examined the relation of ingroup bias to board performance, and they have argued that ingroup bias may adversely affect director behavior.[1184] Directors may be biased in favor of the corporation's executive officers due to social factors, such as reputational and self-image concerns among peers, and professional and personal friendships.[1185] For example, Cox and Munsinger noted that "[w]hen an individual perceives a group, such as his colleagues on the board, as agreeable, not only is he attracted to continued association with the group, but also because of this attraction he conforms his actions to the group's views."[1186] Similarly, Anthony Page noted that "directors may be biased merely due to their role as members

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[1182] Antony Page, *Unconscious Bias and the Limits of Director Independence,* 2009 U. ILL. L. REV. 237, 249 (2009).
[1183] *Id.*
[1184] *See generally* Cox & Munsinger, *supra* note 1117 (examining ingroup bias in the context of director independence and special litigation committees); Page, *supra* note 1182, at 249–59 (examining ingroup bias in the context of director independence); *see also generally* Hill & McDonnell, *supra* note, at 885 (examining structural bias in the non-self-dealing context and arguing that Delaware's new good faith doctrine is not adequate to address structural bias); *see also* Jones, supra note 1172, at 1139–45 (examining social psychology research and arguing that "basic human tendencies including conformity, consistency, and self-justification" may affect director behavior adversely and may cause unethical conduct to occur). It should be briefly noted that some commentators have argued that extralegal forces are important factors that control director conduct, and they sufficiently motivate directors for better behavior. Former Chancellor Allen, for example, argues that "the moral beliefs of members of the groups from which directors are drawn and their concern for reputation among peers" constrain director misbehavior, and there is no need for "liability rules" to enforce directorial responsibilities. Allen, *supra* note 250, at 13. While market incentives and reputational concerns may affect director behavior positively, they alone are not sufficient to assure compliant behavior. Indeed, behavioral research concerning ingroup bias indicates that these factors may have adverse effects on director behavior. *See infra* notes 1185–92 & accompanying text. Further, in his extensive work examining social psychology, Jones convincingly argues that in order for market and social norms to positively influence director behavior, "they must be supported by an external accountability mechanism. Without a reliable accountability mechanism, social norms that guide managerial conduct are likely to erode and tolerate increasing levels of unethical conduct." Jones, *supra* note 1172, at 108. Other commentators recognize that, although market and social incentives are important, they alone are not sufficient to motivate directors to attend their duties diligently. *See* Knees, *supra* note 933, at 236; Bainbridge, *supra* note 13, at 122.
[1185] *See* Cox & Munsinger, *supra* note 1117, at 91–108; Page, *supra* note 1182, at 255–59; Jones, *supra* note 1172, at 141 ("Directors of large public corporations are members of a surprisingly homogeneous group. They overwhelmingly share common social, economic, racial, and religious backgrounds. These common characteristics help cement a culture that emphasizes shared goals and values and discourages open dissent. Problems highlighted in studies of boards—an unwillingness to ask discerning questions, a desire to conceal ignorance, and the perceived obligation to support the CEO—can be explained in part by the tendency to conform and the desire to fit in.") (footnote omitted). *See also* Bernard S. Sharfman & Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron,* 103 NW. U. L. REV. COLLOQUY 153, 154–55 (2008) ("[B]ehavioral scientists have been saying for years that small deliberative groups are prone to error in their decisionmaking if these groups are made up of a majority of members who are similar in position prior to deliberations. Such groups can fall victim to what is referred to as―group polarization—the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations. The corporate board is no exception to this problem.") (footnotes omitted).
[1186] Cox & Munsinger, *supra* note 1117, at 92;

of a board of directors,"[1187] and this can "lead to biased decision making based on unconscious cognitive, affective, and motivational processes."[1188] In the corporate context, this has been referred to as "structural bias."

Structural bias may cause suboptimal director behavior in corporate decision making or oversight.[1189] Directors may tend to unduly defer to the judgment of the executive management in deciding corporate matters.[1190] When directors are called to approve a corporate action, they may conform to the executive management's proposal without much questioning and thoroughly investigating it.[1191] Therefore, the directors' decision may usually be a foregone conclusion.[1192] Similarly, directors may tend to be unduly deferential to the management performance and legal compliance of the corporation's executive officers and, therefore, they may not oversee the corporate business and affairs in an efficient manner. Section 102(b)(7) and its interpretation by Delaware courts do not provide a sound legal environment to address structural bias in corporate board rooms. In the absence of some credible threat of personal liability for inattentive conduct, directors may be inclined to become passive decision makers and overseers by discharging their responsibilities perfunctorily. However, if directors know that their conduct may be subject to judicial review and that they may be exposed to personal liability, they will be naturally induced

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[1187] Page, *supra* note 1182, at 248.
[1188] *Id.* at 251.
[1189] Agency problems arising from centralized management (separation of legal control from beneficial ownership) increase the risk of inattentive director conduct. As one commentator observed:

> The structure of the modem, publicly held corporation lends itself to problems of board inattention. Although corporations are owned by shareholders, they are managed by a board of directors elected by the shareholders. This creates a division between ownership (at the shareholder level) and control (at the director level), which raises the classic 'other people's money' problem. Directors are managing a corporation representing an investment of 'other people's money,' yet, in theory, no one does as good a job managing a business as the business owner herself because she has the most at stake.

Nowicki, *supra* note 1174, at 699.
[1190] *See* Jones, *supra* note 1172, at 139 ("Certain aspects of board culture such as passivity and deference to the CEO allow chronic corporate governance problems to fester.").
[1191] *See* Hill & McDonnell, *supra* note 885, at 860 ("In most cases, directors are giving less care than they should be because they are being deferential and, almost certainly, they feel reasonable in doing so because they have some level of identification or shared perspective with the officers."). Even Professor Bainbridge, who ardently opposes to the enforcement of the duty of care, acknowledges this point. He observed: "In practice, of course, many boards of directors are captured by the firm's senior management and simply rubberstamp management decisions." Bainbridge, *supra* note 13, at 105.
[1192] For example, in the famous corporate law cases of *Van Gorkom* and *Disney*, the challenged board decisions were arguably foregone conclusions. In *Van Gorkom*, the board approved the sale of the corporation in a two-hour meeting upon twenty minutes oral presentation of the chairman. *See supra* Chapter III.E.1. In *Disney,* the board of directors approved the employment of Michael Ovitz after it was publicly announced. *See supra* Chapter IV. B.2.a.

to act more responsibly. One commentator nicely illustrated how some credible threat of personal liability would assist overcoming structural bias as follows:

> Most directors—even the most responsible and diligent directors—will have some inhibition about openly questioning and criticizing the actions of [senior officers]. Importantly, the prospect of liability will often provide the justification (or excuse) for those kinds of conversations to occur within the boardroom's collegial setting. We can imagine a director saying something like, 'Of course we have the utmost faith in you, Sally, but the lawyers insist we ask you the following for the record. . . .' Thus, *the symbolic existence* of personal liability, even though its practical consequences may be mitigated by private-ordering arrangements such as indemnification and insurance, may play an important role in assisting the directors, aided by the corporation's lawyer, to fulfill their monitoring and oversight functions.[1193]

Traditionally, the duty of care has been the primary legal tool to address inattentive director conduct. The common law imposes the duty of care to assure that directors discharge their board responsibilities diligently, attentively, and on an informed basis. By permitting the exculpation of monetary liability for conduct lacking due care, section 102(b)(7) obliterates any meaningful threat of punishment for inattentive decision making and oversight. A section 102(b)(7) provision practically precludes a shareholder from bringing a derivative action based on a duty of care claim. Therefore, in the post-exculpatory era, '"the fiduciary duty of care exists only as an aspirational and unenforceable standard,' except in actions for injunctive relief."[1194] This may not be adequate to address the board inattention problem. Directors should not be afforded a free-pass to ignore their due care responsibilities. As former Chancellor Allen observed:

> [U]ndeniably [a] strong protection appears to have [ ] its dark side. Public company directors, having neither substantial investment risk nor liability risk, might well tend to become passive. Indeed it is to try to assure director engagement or attentiveness that the law imposes a fiduciary duty of care in the first place.[1195]

The standard of conduct required of directors under the duty of care is vitally important in performing board service. The key element of the duty of care is information, and information is one of the key elements of business success. In the decision-making context, the duty of care requires directors to employ an informative and deliberative process. In the oversight context, it requires directors to pay an informed and ongoing attention to the business and affairs of the corporation. Directors' failure to act with due care may significantly harm a corporation.

[1193] Davis, *supra* note 17, at 586 (emphasis added).
[1194] Holland, *supra* note 10, at 692–93 (citation omitted).
[1195] Allen, *supra* note 250, at 13.

In modern corporations, a board of directors primarily functions as a control mechanism over the corporation's executive officers. The duty of care requires directors to perform their functions truly by taking an active and direct role in corporate decision making and oversight.[1196] Accordingly, the duty of care is in place to assure that a board of directors properly serves the very purpose for which it was designed.[1197] As such, the law should put appropriate systems into place to assure that directors engage in informed decision-making and oversight by exercising due care. This is necessary for ensuring a healthy functioning of the corporate system. As one commentator observed:

> [D]irector inattention is a problem because it undermines investor confidence. When investors lose confidence in the management of the modem corporation, they stop investing in stocks and corporations, which tightens capital market liquidity and limits corporate expansion. Further, as an academic matter, director inattention throws into question the utility of the corporation as a business entity. One of the key benefits to the corporate form is that it allows for passive investment because management is the responsibility of directors. If the directors are inattentive, this undermines the utility of passive investment. Corporations utilize a management structure that vests 'control' of the corporation into the hands of directors who are elected by shareholders. If directors are not performing their control functions, the corporation is not working as designed.[1198]

It is also a reality, however, the enormous scope of potential monetary liability for a due care breach, coupled with the fact-specific nature of the duty of care,[1199] would have counter-effects on director behavior. A breach of the duty of care subjects directors to personal liability for the entire amount of economic harm to the corporation that results from flawed decision making or oversight. For a multibillion dollar corporation, a single mistake could result in a multimillion of dollar damage award against directors. This may discourage competent people from serving on corporate boards and may reduce the efficiency of corporate decision making. Further, personal liability for a due care breach raises serious fairness concerns. The liability that directors could face for a due care breach appears to be "disproportionate in relation to the degree of wrongdoing."[1200] As one commentator nicely explained:

> The measure of damages is not directly related to an individual director's degree of culpability or the benefit received by the director. Even for a director who erred in approving a transaction or who disregarded evidence of misconduct, such a result seems unfair. A director who lacked intent

[1196] Veasey & Di Guglielmo, *supra* note 742, at 1419 ("Directors are not merely the group that hires and fires the CEO and is expected simply to advise management. They must be proactive in directing the management.").
[1197] *See* CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 6, at 2. ("The key challenge for directors is to oversee the corporation's activities and strategy by utilizing effective oversight processes and making informed decisions, without becoming day-to-day managers.").
[1198] Nowicki, *supra* note 1174, at 700–01.
[1199] *See infra* note 1216.
[1200] Jones, *supra* note 1172, at 111.

> to harm the corporation or was unaware of the potential consequences of a failure to act is not the most blameworthy agent … for the corporation's losses.[1201]

Further, the public policy underlying the duty of care is not to require directors to compensate for corporate damages resulting from faulty actions or inactions. "It is generally agreed that recovery in fiduciary duty lawsuits is more about deterrence than about making the corporation or its shareholders whole."[1202] Accordingly, it may be appropriate to provide directors an adequate—not absolute—protection from personal liability arising from "conduct undertaken in good faith, but which nevertheless constitutes breach of the duty of care."[1203]

Therefore, there are two competing values in the duty of care context: first; the need to promote directorship service and risky decision making and, second; the need to deter noncompliant behavior and to induce a diligent attendance to directorial responsibilities.[1204] Because the human quality and risk are essential elements of business success and innovation, the law should free directors from the fear of monetary liability for corporate losses. On the other hand, behavioral psychology suggests that a credible accountability mechanism is necessary to encourage compliant behavior. Awareness of being monitored induces heightened actor attentiveness. Accordingly, there should be an appropriate legal mechanism setting a fair balance between the two competing values.

Preferring one value over another is not an appropriate way to ensure a healthy functioning of the corporate system. Substantial exposure to personal liability may cause over-cautious and risk-averse director behavior. Lack of an accountability mechanism may make

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1201 *Id.* at 148.

1202 Nowicki, *supra* note 1174, at 716 ("Indeed, there tends to be little relationship between the amount recovered and the harm suffered."). *See also* Davis, *supra* note 17, at 575. He explains that the tort system shifts "the loss from a single human victim and spread[s] it, by means of insurance and doctrines such as respondeat superior, across a larger, more diversified group." *Id.* As he observed, this system works opposite way in the corporate context:

> At least in the case of larger, publicly held corporations, directors' liability has just the opposite effect. Absent liability, the loss is spread across the portfolios of the pension funds, mutual funds, and other institutional and individual investors who hold the corporation's stock. Imposing liability on the directors serves to re-concentrate this loss on a small handful of individuals. For a large corporation, this means that each member of the board might easily face potential personal liability well in excess of a million dollars.

Id.

1203 1 RADIN, *supra* note 161, at 744.

1204 In a broader context, Professor Bainbridge conceptualized these competing values as the "tension between authority and accountability." Bainbridge, *supra* note 13, at 86. He identifies this tension as the "as the central problem of corporate law." *Id. See also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A. 2d 914, 927 (Del. 2003) ("The 'defining tension' in corporate governance today has been characterized as 'the tension between deference to directors' decisions and the scope of judicial review.'") (citing E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 403 (1997)).

directors comfortable with sloppy behavior. Further, it may encourage *incompetent* people, who are unwilling to give necessary attention to corporate matters, to serve on corporate boards. An efficient enforcement mechanism of due care responsibilities should not be sacrificed for the sake of corporate risk-taking. Rather, the competing values should be aligned under an appropriate legal framework. The law must try to assure director engagement to due care responsibilities while providing an adequate protection from personal liability.

As discussed throughout this chapter, section 102(b)(7) does not serve this end. The liability shield of section 102(b)(7) and its procedural impact devastate the efficacy of the duty of care. A section 102(b)(7) provision practically forbids a shareholder from challenging "mere" inattentive director conduct. Under section 102(b)(7), "the fulcrum point between director authority and accountability has been pushed too far in favor of director authority."[1205] Delaware courts' recent attempt to regenerate a liability threat for inattentive conduct under the good faith doctrine was not fruitful. Requiring a plaintiff to plead a duty of loyalty claim by demonstrating bad faith at the outset of a derivative lawsuit practically closes a court's door to a shareholder whose corporation suffers from inattentive director conduct. Although intentional abdication of directorial responsibilities is technically actionable under the duty of loyalty, a combination of substantive doctrines and procedural requirements prevent shareholders from challenging nonpecuniary misconduct. In the presence of an exculpatory provision, even a meritorious derivative claim challenging inattentive director conduct is likely to fail to survive a motion to dismiss. Therefore, the liability regime created by section 102(b)(7) is not adequate to motivate directors to be engaged, attentive corporate decision-makers and overseers.

Nowicki proposes a revision of section 102(b)(7) in the form of a liability cap.[1206] She argues that directors should face some credible threat of personal liability for inattentive conduct. She also acknowledges, however, holding directors liable for catastrophic corporate losses for a due care breach may not be appropriate. Under her proposal, the directors' liability exposure for inattentive but good faith conduct is limited to a reasonable amount. She proposes that the formulation of section 102(b)(7) should be replaced with the following formulation authorizing a corporation's certificate of incorporation to include:

> A provision limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of a fiduciary duty to the greatest of (i) the benefit received by the

[1205] Knees, *supra* note 933, at 235.
[1206] *See* Nowicki, *supra* note 1174, at 712.

> director as a result of the fiduciary duty violation, (ii) the compensation received by the director from the corporation in the year or years of the fiduciary duty violation, or (iii) $80,000; provided that such a provision shall not limit a director's liability for willful misconduct, for a knowing violation of the law (including, without limitation, any claim of unlawful insider trading or manipulation of the market for any security), or under section 174 of this title; and provided that the amounts in (i), (ii), or (iii) cannot be indemnified and cannot be insured.[1207]

Under her proposal, directors could be held personally liable for a broader scope of conduct than section 102(b)(7), and the dollar amount of a directors' personal liability exposure would be capped.

Jones contests this proposal by arguing that "any dollar amount proposed as a damages cap is necessarily arbitrary and may be insufficient to induce the desired behavior."[1208] Further, as Nowicki acknowledges as well, the plaintiffs' bar may be unwilling to take cases that are subject to caps because attorneys' fees in a fiduciary duty violation case are often calculated based on the recovery achieved.[1209] Thus, capped recovery may "dissuade good attorneys from taking even compelling fiduciary duty [of care] cases."[1210]

This dissertation proposes an alternative approach in order to revive the duty of care while providing directors an adequate protection from personal liability. It recognizes that directors should not be held personally liable for corporate losses as long as they act in good faith. It also recognizes the need for an effective enforcement mechanism of the duty of care in order to induce directors for compliant behavior. The premise of this dissertation's proposal is that directors should not be afforded *ex ante* protection from monetary liability for a duty of care violation; rather, they should be entitled to an *ex post* good faith defense to avoid monetary liability for corporate losses that may result from flawed decision making or oversight. It argues that whether directors breached their duty of care and whether personal liability should attach to that breach should be treated as two distinct questions. A due care breach should not result in per se imposition of personal liability for money damages. Accordingly, this dissertation argues for a

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[1207] *Id.*

[1208] Jones, *supra* note 1172, at 154. Alternatively, he proposes that (grossly) negligent directors should "make personal payments toward settlements and damage awards, and that such payments should be calibrated based on a director's ability to pay." *Id.* at 105. In other words, "personal monetary liability should be calibrated so that each director suffers a financial setback, but no director is financially devastated." *Id.* at 152.

[1209] Nowicki, *supra* note 1174, at 717.

[1210] *Id.* She argues that this objection to liability cap lacks merit because "Delaware courts have discretion in awarding attorneys' fees in shareholder litigation against directors." *Id*. Accordingly, if potential liability is capped, "attorneys for the plaintiff-shareholders who request an award of fees could argue for fees based not on the amount recovered in the lawsuit but rather on the intangible benefit to the corporation for vindicating a wrong, or alternatively, on the hours spent on the litigation." *Id.*

middle-ground approach—one that protects directors from monetary liability for good faith conduct but also recognizes the need to empower shareholders to encourage and enforce director compliance with due care responsibilities.

Section 102(b)(7) was enacted as a response to the Delaware Supreme Court's holding in *Van Gorkom*.[1211] The duty of care analysis of the *Van Gorkom* court significantly increased the fear of personal liability among corporate directors. However, the *Van Gorkom* court's teaching is of paramount significance in corporate decision making. The gist of *Van Gorkom* is that directors should make a business decision on a credible basis by employing an informative and deliberative process. This dissertation argues that section 102(b)(7) was an overreaction to *Van Gorkom*. It undermined the importance of *Van Gorkom*'s teaching that directors should deliberate in an informed manner before making a business decision. This dissertation attempts to rectify the objectionable doctrinal aspects of *Van Gorkom* while preserving its gist.

In *Van Gorkom*, the Delaware Supreme Court found the defendant directors to have lost the protection of the business judgment rule for breaching their duty of care and thereby exposed them to potentially catastrophic personal liability.[1212] The court remanded the case to the trial court for a determination of damages based on "the extent that the fair value of Trans Union exceeds" the challenged sale price.[1213] Accordingly, the court held that grossly negligent conduct *not only rebuts* the business judgment rule presumption *but also requires* imposition of personal liability for money damages.

Commentators largely criticized the *Van Gorkom* court for making an entirely objective evaluation of the challenged decision-making process and for disregarding the special and subjective circumstances under which the decision was made.[1214] The subjective factors of the case, such as impeccable credentials of the defendant directors as business men, their familiarity with financial status of the corporation, and the expertise of the chairman in the merger and acquisitions processes, played no role in shaping the opinion of the majority of the court. Commentators were also critical that the substantive quality of the challenged decision played no

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[1211] *See Malpiede,* 780 A.2d at 1095. ("Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom.*") (footnote omitted).
[1212] *Van Gorkom*, 488 A.2d at 881.
[1213] *Id.* at 893.
[1214] *See supra* Chapter III.E.1. (discussing *Van Gorkom* and scholarly response). *See also supra* Chapter III.C.1.a. (discussing *Van Gorkom* in the gross negligence context).

role in the court's due care analysis.[1215] The approved sale price represented a substantial premium over the value of the company in the stock market. Further, the defendant directors acted in good faith in approving the sale of the company. The fact that the court imposed potentially catastrophic liability on the defendant directors for a decision made in good faith outraged corporate law community. Thus, the Delaware Supreme Court's holding in *Van Gorkom* received harsh criticism primarily for two reasons: first, for applying an entirely objective test to evaluate challenged conduct with an exclusive focus on the process, and second, for imposing personal liability on directors who acted in good faith.[1216]

[1215] *See supra* notes 675–80 & accompanying text.

[1216] Indeed, the *Van Gorkom* case represents the problematic aspect of the duty of care (the negligence concept) in the corporate director context. The fact-specific nature of the duty of care increases the risk of directors' liability exposure. There is no prescribed procedure that directors can follow to avoid a breach of the duty of care and personal liability. Corporate matters that directors deal with encompass a wide variety of situations, and it is very difficult to provide a pre-set formula that directors must follow to act with due care. "[T]he exact course of conduct that must be followed to properly discharge their responsibilities 'will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders.'" Holland, *supra* note 10, at 682 (citing Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998)). Accordingly, the directors' duty of care is defined by standards rather than specific rules. This aspect of the duty of care raises several problems in the corporate context. As former Chancellor Allen observed with two other colleagues:

> The difficulties with the common law case-by-case form of fiduciary regulation are several. By its nature fiduciary duty law is an imperfect tool to forge rules to regulate a phenomenon as complex and policy-laden as corporate takeovers. Being highly general, prospective statements of the content of fiduciary duties offer limited guidance to transaction planners who seek legal certainty from authoritative judicial decisions. Moreover, as applied in specific cases the articulated fiduciary duty is often so highly particularized that it becomes difficult to generalize *ex ante* rules from those judicial holdings. To express it differently, the almost infinite potential variation in the fact patterns calling for director decisions, the disparate time frames within which different boards may be required to act, and the divergent skills and information needed to make particular business decisions, usually make it impossible for courts to articulate *ex ante* precise guidelines for appropriate fiduciary action in future cases. Given the blunt nature of the fiduciary doctrine tool, judges must instead describe fiduciary duties in general terms that can (it is hoped) be sensibly and fairly applied in future diverse circumstances in which directors are called upon to act. In discharging this task, judges also face the difficulty of bringing *legal* expertise to bear in reviewing the decisions of *business* professionals, an exercise inherently fraught with risks of error.

Allen, Jacobs & Strine, *supra* note 18, at 1294 (emphasis in original) (footnote omitted). Delaware courts attempted to balance the fact-specific nature of the duty of care by applying a lenient standard of gross negligence to review the directors' decisional process. However, the *Van Gorkom* holding triggered a doctrinal controversy with respect to the gross negligence standard. Many commentators criticized the holding by arguing that the challenged decisional process was not grossly negligent. While it is uncontestable that the standard of gross negligence is less exacting than the typical due care standard of ordinary negligence, these two standards differ only in degree, not in kind. It is hard to draw a clear line between them. There are no hard and fast rules defining the concept of gross negligence, as there is no pre-set formula for directors to comply with the duty of care. What constitutes grossly negligent conduct may substantially change from one case to another. Further, as the former Chief Justice of the Delaware Supreme Court observed, there is some risk that hindsight bias will color a court's "assessment of what an acceptably good process would have been or would have produced." Veasey & Di Guglielmo, *supra* note 742, at 1424. Therefore, it may be more appropriate that the directors' personal monetary liability be predicated upon the

This dissertation argues that a finding of a due care breach should not automatically establish personal liability for damages that the corporation may have suffered as a consequence. Rather, it should only shift the burden to the defendant directors to demonstrate that they made a good faith effort to exercise an informed business judgment. Directors should convince the court that they honestly believed that they exercised appropriate care under the circumstances of the case.[1217] In other words, directors should justify their process failure on the basis of good faith. Thus, the test for determining a due care breach should be predicated upon an objective gross

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concept of good faith. Moreover, due to the widespread adoption of exculpatory provisions, the predominant rule in corporate law in the twenty-first century is that directors should not be held monetarily liable for nonpecuniary misconduct as long as they act in good faith. It is also necessary, however, to maintain the gross negligence standard for reviewing directors' decisional process in order to encourage them to employ an appropriate process before making a decision. Under this dissertation's proposal, Delaware's emphasis on process would be maintained, and the controversy with respect to the gross negligence standard would be eliminated because grossly negligent conduct leads only to a subjective inquiry with respect to good faith. *See supra* Chapter III.C.1.a. (examining scholarly commentary with respect to the gross negligence standard).

[1217] This dissertation does not attempt to provide a precise standard to determine whether directors acted in good faith where the business judgment rule is rebutted solely on the ground of the duty of care. Rather, it argues that courts should employ a flexible approach and consider all relevant factors to determine whether the defendant directors believed that the deficient decisional process was appropriate under the circumstances. PCG § 4.01(c)(2) requires directors to be "informed with respect to the subject of the business judgment to the extent the director or officer *reasonably believes* to be appropriate under the circumstances." PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c)(2) (emphasis added). "[T]he term 'reasonably believes' has both an *objective* and a *subjective* content." PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. e. (emphasis added). This dissertation basically proposes a replacement of the term "reasonably believes" with the term "honestly believes" because the term "reasonable" represents the objective inquiry. In Delaware, the objective test is initially performed under a gross negligence standard for determining the applicability of the business judgment rule. Therefore, where the challenged decisional process fails to satisfy an objective test, the focus should shift to a subjective test under the entire fairness standard. This dissertation proposes that this subjective inquiry should be directed to directors' good faith. The "reasonable belief" test is explicated under PCG § 4.01(c) cmt. e. A replacement of the term "reasonably" with the term "honestly" in the PCG's commentary would assist explaining this dissertation's approach:

> There is no precise way to measure how much information will be required to meet the '[honest] belief' test in given circumstances. Among the factors that may have to be taken into account in judging a director's [honest] belief as to what was 'appropriate under the circumstances' are: (i) the importance of the business judgment to be made; (ii) the time available for obtaining information; (iii) the costs related to obtaining information; (iv) the director's confidence in those who explored a matter and those making presentations; and (v) the state of the corporation's business at the time and the nature of competing demands for the board's attention. The different backgrounds of individual directors, the distinct role each plays in the corporation, and the general value of maintaining board cohesiveness may all be relevant when determining whether a director [honestly believed] that the information before him or her was 'appropriate under the circumstances.'
>
> Of course, the business or professional experience of directors or officers may help to inform them about a decision. They may also be informed by the general views or specialized experience of colleagues…

PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmt. e.

negligence concept, and the test for determining personal liability for a due care breach should be predicated upon a subjective good faith concept.

In the decision-making context, Delaware's business judgment rule may provide a fertile ground for this dissertation's proposal.[1218] In *Cede v. Technicolor*, the Delaware Supreme Court held that rebuttal of the business judgment rule shifts the burden to the defendant directors to prove that the challenged action or transaction was entirely fair to the corporation and its shareholders.[1219] Accordingly, if the plaintiff rebuts the business judgment rule on the basis that the decision was uninformed, the burden shifts to the defendant directors to satisfy the entire fairness standard. Importantly, as the *Cede I* court emphasized, burden shifting to the defendant directors to show the entire fairness of the challenged decision "does not create *per se* liability on the part of the directors."[1220] After *Cede I*, a breach of the duty of care does not directly result in personal liability for money damages. Rather, "the determination that a board has failed to demonstrate entire fairness will be the basis for a finding of *substantive* liability."[1221] As the Delaware Supreme Court stated:

> Because the decision that the *procedural* presumption of the business judgment rule has been rebutted does not establish *substantive* liability under the entire fairness standard, such a ruling does not necessarily present an insurmountable obstacle for a board of directors to overcome. Thus, an initial judicial determination that a given breach of a board's fiduciary duties has rebutted the presumption of the business judgment rule does not preclude a subsequent judicial

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[1218] It should be noted that, in Delaware law, it is not clear whether a rebuttal of the business judgment rule by a showing of grossly negligent decision-making process requires directors to prove the entire fairness of the challenged decision where directors are protected from personal liability by a section 102(b)(7) provision. In *Emerald Partners*, the Delaware Supreme Court held that

> when the presumption of the business judgment rule has been rebutted in the shareholder complaint solely by successfully alleging a duty of care violation, the director defendants do not have to prove entire fairness to the trier of fact, because of the exculpation afforded to the directors by the Section 102(b)(7) provision inserted by the shareholders into the corporation's charter.

Emerald Partners, 787 A.2d at 92. The court reiterated this point by stating that a corporation's section 102(b)(7) provision obviates "a trial pursuant to the entire fairness standard, even if the presumption of the business judgment rule is successfully rebutted by a duty of care violation, since liability for duty of loyalty violations or violations of good faith are not at issue." *Id.* However, in *Disney*, the Delaware Supreme court's analysis into the challenged decision included "due care determinations." *Disney*, 906 A.2d at 52. After *Disney*, one may argue that a rebuttal of the business judgment rule by a showing of grossly negligent conduct requires directors to satisfy the entire fairness standard. In that case, where directors fail to satisfy the entire fairness standard, the question arises whether they will be held liable for money damages. It is difficult to argue that Delaware courts would impose liability for money damages where the corporation's certificate include a section 102(b)(7) provision and the business judgment rule has been rebutted *solely* by successfully showing grossly negligent conduct.

[1219] 634 A.2d 345, 361 (Del. 1993) [hereinafter *Cede I*].

[1220] *Id.* at 371 (emphasis in original).

[1221] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1165 (Del. 1995) (emphasis in original) [hereinafter *Cede II*].

> determination that the board action was entirely fair, and is, therefore, not outcome-determinative *per se.*[1222]

The entire fairness standard has two basic components: fair dealing and fair price.[1223] The fair dealing component relates to "how the board action was initiated, structured, negotiated, and timed."[1224] The fair price component concerns "the economic and financial considerations of the proposed decision."[1225] Under an entire fairness review, a court closely scrutinizes all aspects of a decision or transaction, including its process and substantive merits. An entire fairness review requires "exacting scrutiny to determine whether the transaction [or the decision] is entirely fair to the stockholders."[1226] A court "must carefully analyze the factual circumstances" by "taking into account all relevant factors."[1227] In fairness review, directors must present evidence "regarding the manner in which the board otherwise discharged all three of its primary fiduciary duties."[1228] As the *Cede II* court stated, "irrespective of the particular breach or breaches of fiduciary duty that constituted the basis for shifting the *procedural* burden of proof to the board, *each* of the fiduciary duties retains independent *substantive* significance in an entire fairness analysis."[1229]

The *Cede II* court stated that, "arm's-length negotiation provides 'strong evidence that the transaction meets the test of fairness.'"[1230] The *Cede II* court also emphasized that "[t]he independence of the bargaining parties is a well-recognized touchstone of fair dealing."[1231] In a duty of care case, the primary concern is a deficient decision-making process, not director independence or self-interest. Accordingly, although the entire fairness standard includes an exacting judicial inquiry into substantive merits of a decision, it is not very difficult for directors to satisfy it where the business judgment rule is rebutted solely on the ground of the duty of care.

Further, despite the grossly negligent decision-making process, the directors' good faith with respect to the process and substance of the challenged decision play an important role in an entire fairness review. "Even after evidence of a breach of the duty of due care has rebutted the

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1222 *Id*. at 1163 (emphasis in original).
1223 Int'l Telecharge, Inc. v. Bomarko*,* 766 A.2d 437, 440 (Del. 2000).
1224 *In re* Digex, Inc. S'holders Litig.*,* 789 A.2d 1176, 1207 (Del. Ch. 2000).
1225 *Id.*
1226 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994).
1227 *Cede II*, 663 A.2d at 1179.
1228 *Id.* at 1164.
1229 *Id*. (emphasis in original).
1230 *Id.* at 1172 (quoting Weinberger v. UOP. Inc., 457 A.2d 701, 709–10 n.7 (Del. 1983)).
1231 *Id*. at 1173.

procedural presumption of the business judgment rule, the degree of care that the board actually exercised remains relevant."[1232] Accordingly, a court reassesses a board's failure in the decision-making process in light of "the board's good faith and the arm's-length negotiations" and other relevant facts.[1233] In *Cede II*, considering all relevant factors, the court concluded that the challenged transaction was entirely fair despite the defendant directors' grossly negligent decisional process. The *Cede II* holding indicates that Delaware courts give significant deference to directors' good faith under an entire fairness analysis. Thus, directors who are found to have breached their duty of care but nevertheless acted in good faith could demonstrate the entire fairness of the challenged transaction.

The entire fairness standard "is traditionally tied to situations involving self-dealing—in other words, *loyalty* cases."[1234] Where directors have a pecuniary conflict of interest in a corporate transaction, Delaware courts closely scrutinize the transaction to determine whether it was fair to the corporation. In reviewing a self-interested transaction, judicial inquiry necessarily focuses on the fair price component, because the primary concern in this context is to determine whether the defendant directors profited at the expense of the corporation and its shareholders. As the Delaware Chancery Court observed:

> [The entire fairness review] has been said to require that the proponents of a conflicted merger demonstrate that they proceeded in a manner that was both procedurally and substantively fair. That is more than a bit of a misnomer, as the overriding consideration is whether the substantive terms of the transaction were fair. Thus, it has been said that the two-part fairness test is not a bifurcated one; rather, all aspects of the transaction are examined as a whole in order to aid

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[1232] *Id*. at 1175. One commentator criticized the application of the entire fairness standard in a duty of care case as follows:

> *Cede*'s burden shift and entire fairness approach to a care breach simply led to a judicial assessment of factors which should have been done as part of a more thorough threshold duty of care analysis. Recognizing the care-like nature of the factors it was evaluating in its entire fairness review, the court could only rationalize its two-stage care analysis by stating that the 'degree of procedural due care a board of directors exercises has been recognized as a continuing component of an entire fairness analysis.' What later comprised the court's 'fair dealing' portion of its entire fairness analysis should have been done as part of the initial due care inquiry.

Johnson, *supra* note 251, at 648 (citation omitted). However, this approach would diminish the importance of an appropriate decision-making process. If a court evaluates the decisional process under gross negligence standard with a nexus to subjective elements of the case, the emphasis on an informative and deliberative decision-making process would be undermined. Under *Cede*'s approach, directors would be encouraged to employ a good decision-making process to avoid entire fairness analysis. Good processes presumably produce good results, and the emphasis on the process should be preserved. *See* Sale, *supra* note 917 at 2 (praising Delaware's approach by stating that "[i]t pushes fiduciaries to focus on processes and procedures, while avoiding the delineation of specifics because when circumstances change, specifics are less useful").

[1233] *Cede II*, 663 A.2d at 1175.

[1234] Veasey & Di Guglielmo, *supra* note 742, at 1426 (emphasis in original).

> in coming to the bottom-line conclusion of whether the transaction was fair. In a *non-fraudulent* transaction, therefore, '*price may be the preponderant consideration* outweighing other features of the merger.'[1235]

In the duty of care context, however, the primary issue is not the directors' self-interest; it is rather a flawed decision-making process.[1236] In a duty of care case, the challenged transaction is presumably structured in an arms-length bargaining process based on market competition. Accordingly, where the business judgment rule is rebutted by a showing of lack of due care, directors' independence, lack of self-interest, and good faith belief that the transaction was in the best interests of the corporation should be interpreted as a strong evidence for meeting the entire fairness test. In other words, where directors' decisional process failed the objective gross negligence test, a subjective inquiry into the flawed decisional process on the basis of good faith should dominate the entire fairness review. An entire fairness standard should not require directors to demonstrate that their grossly negligent decision making caused no harm to the corporation. Even though a grossly negligent decisional process results in harm to the corporation, this should not preclude a finding of entire fairness if directors can demonstrate that they honestly believed that the challenged decisional process was appropriate under the

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[1235] Delaware Open MRI Radiology Associates, P.A. v. Kessler, 898 A.2d 290, 311 (Del. Ch. 2006) (emphasis added) (citation omitted).

[1236] Indeed, a robust application of the entire fairness standard may not be suitable in the duty of care context. *See* Allen, Jacobs & Strine, *supra* note 208, at 461–62. They criticized the application of the entire fairness standard in a duty of care case as follows:

> First, the basic rationale for entire fairness review—the difficulty in ascertaining, in non-arms-length transactions, the price at which the deal would have been effected in the market—is not applicable in due care cases. 'Care cases, unlike loyalty cases, do not deprive corporations of 'neutral decisionmakers.'' In the due care context the plaintiff should be able to identify whatever harm flowed from the neutral decision-makers' alleged breach of care, which obviates any need for a court to assess the substantive fairness of the board's business decision.
>
> Second, in care cases not involving a specific transaction, an entire fairness analysis would have little or no utility. The reason is that due care cases in nontransactional settings (for example, uninformed or otherwise careless decisions on corporate distributions, or decisions to expand or contract a business by means other than by acquiring or divesting an entire corporation) do not involve discrete market-based events that lend themselves to a fairness analysis. That is also true of nontransactional director conduct such as a failure to monitor the conduct of corporate employees. Thus, the *Cede II* analytical framework could not be used as a uniform review standard applicable in all due care cases, which raises fundamental questions of what are the outer limits and contours of the *Cede II* doctrine.

Id. (citations and footnotes omitted). *See also* Bainbridge et al., *supra* note 859, at 587 (arguing that the entire fairness standard is technically not applicable in duty of care and bad faith cases). For example, if directors approve a business project (e.g., a new product) in a grossly negligent manner, and if the project results in a corporate loss, it would make little sense to review whether the result of the decision was fair ("fair price") to the corporation. In that case, the judicial inquiry necessarily should focus on the "fair dealing" component.

circumstances and that they approved the challenged decision in good faith to advance the best interests of the corporation.

Accordingly, this dissertation proposes that the entire fairness standard should play a mitigating role between a duty of care breach and personal liability for money damages.[1237] When reviewing grossly negligent decision-making under an entire fairness standard, the specific focus of the judicial scrutiny should be whether directors acted in good faith. A court should closely scrutinize all relevant factors of the case to determine whether the challenged conduct was taken in good faith. For example, directors' business expertise, their general knowledge about the corporation, and the time constraints may be weighed against the deficient decisional process for determining directors' good faith.[1238] In *Cede II,* the court gave consideration to the fact that the CEO of the company, who led the negotiations in the merger process, was informed about the strengths and weakness of the company, and he was an active and experienced CEO.[1239] The court also gave consideration to the fact that the proposed sale price included a substantial premium over the corporation's market value.[1240] As such, a court should reassess grossly negligent decisional processes in light of all relevant factors with a nexus to the substantive merits of the decision and subjective good faith of the directors. Under an entire fairness review, directors should establish to the court's satisfaction that the deficient process and the resulting decision were a product of a good faith attempt to advance the best interests of the corporation. If directors are able to demonstrate that, despite the grossly negligent process, they otherwise acted in good faith, it should preclude the imposition of personal liability for monetary damages.

Where a plaintiff brings a duty of care action by alleging an oversight failure, the business judgment rule is not applicable. Nevertheless, Delaware courts apply a lenient standard of gross negligence for reviewing oversight claims. Therefore, a plaintiff must establish facts demonstrating that directors failed to discharge their oversight responsibilities in a grossly negligent manner. Directors then should bear the burden to demonstrate that, despite the specific

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[1237] The flexible nature of the entire fairness standard provides a fertile ground for this dissertation's proposal. As the Delaware Supreme Court observed, '"perfection is not possible, or expected' as a condition precedent to a judicial determination of entire fairness. The standard of entire fairness is also not in the nature of a litmus test that 'lend[s] itself to bright line precision or rigid doctrine."' *Cede II*, 663 A.2d at 1179 (citations omitted).
[1238] *See supra* note 1217.
[1239] *Cede II*, 663 A.2d at 1178.
[1240] *Id.*

oversight failure, they have otherwise made a good faith effort to discharge their oversight responsibilities. The *Caremark* standard would neatly fit to determine whether directors acted in good faith to discharge their oversight responsibilities. Under the *Caremark* standard, directors should demonstrate that they installed appropriate monitoring and reporting systems to be informed of corporate business and affairs and that they periodically reviewed the information flowing through such systems. In another words, directors should convince the court that the complained of failure or inaction was not a result of a sustained and systematic shirking of oversight responsibilities. If they fail to do so, they should be then liable for the consequences of the misconduct.

To sum up, this dissertation proposes the repealing of section 102(b)(7) of the Delaware General Corporation Law because it devastates the viability of a duty of care action by permitting *ex ante* protection from monetary liability for a due care breach. This may cause director inattentiveness. There should exist a proper legal mechanism to enforce the duty of care. This dissertation argues that shareholders should be able to bring a duty of care claim. It proposes a two-step judicial analysis to determine whether directors should be held liable for money damages in the duty of care context. First, a court should review directors' due care compliance under a lenient gross negligence standard. Second, where directors' conduct fails to satisfy the gross negligence standard, the court should determine whether directors acted in good faith. Personal monetary liability should be imposed only if the wrongful conduct was not taken in good faith. In the decision-making context, a plaintiff must rebut the business judgment rule by demonstrating grossly negligent conduct. This should lead to a thorough examination of all aspects of the challenged decision under the entire fairness standard with the burden on the defendant directors to demonstrate their good faith with respect to the deficient decisional process and the resulting decision. In the oversight context, a plaintiff must prove that directors failed to discharge their oversight responsibilities in a grossly negligent manner. The burden then should shift to the defendant directors to satisfy the *Caremark* standard by demonstrating that they made a good faith effort to discharge their oversight responsibilities.

Under this dissertation's proposal, the distinct roles played by the directors' fiduciary duties of loyalty and care would be preserved. Shareholder derivative suits would play a meaningful and appropriate role in curbing inattentive director conduct. The directors' due care failures would be subject to judicial review at the instance of shareholders. If directors knew they might be required to account to courts on the basis of good faith for their decisional process and oversight failures, they would be motivated to act more responsibly.[1241] To avoid the time, expense, and publicity of a lawsuit, directors surely would try to discharge their due care responsibilities properly. Under this dissertation's proposal, directors would not be exposed to a substantial threat of personal liability. This would encourage competent people to serve on corporate boards and make risky business decisions. Still, this dissertation's proposal preserves the symbolic existence of personal liability. This minimal threat of liability is necessary to assure director engagement to board responsibilities.[1242]

One may argue that there is no substantial difference between this dissertation's proposal and the liability regime created by section 102(b)(7). After all, section 102(b)(7) excludes "acts or omissions not in good faith" from exculpable conduct, and this dissertation proposes that directors should not be held liable for a due care breach as long as they acted in good faith. The critical difference is that this dissertation's proposal does not provide *ex ante* protection from due care liability. The directors' awareness of being monitored and the "mere" threat of litigation with minimal risk of personal liability would improve increased attention and responsible behavior. Section 102(b)(7) does not serve this end because it virtually excludes nonpecuniary misconduct from judicial scrutiny. It practically confines the scope of shareholder derivative lawsuits to self-dealing director transactions. The procedural protective devices and substantive doctrines create a formidable bar for fiduciary claims against disinterested and independent directors.

[1241] *See* Jones, *supra* note 1172, at 1141. The board studies he examined support the view that mere threat of litigation would promote better director behavior. He observed:

> Executives acknowledge that their perfunctory accountability to the board strengthens their decision-making practices. Knowing that they will have to account to the board for their decisions compels executives to examine the costs and benefits of their proposals and develop a coherent rationale for a proposed course of action.

Id. Similarly, the possibility that directors might be required to defend themselves in a court room for deficient decisional process or oversight failures would induce them to discharge their duty of care properly.

[1242] *See* Davis, *supra* note 17, at 587. He observed as follows:

> The threat of liability and the director's interest in his or her professional stature no doubt interact in other important ways. No high profile business or community leader wants to see his or her name in a court decision or newspaper as a defendant in a suit for sloppy performance as a director, even if the existence of indemnification or insurance assures that he or she faces no out-of-pocket loss. Without the existence of an enforceable legal duty, and the resulting prospect of litigation, this risk of adverse publicity for what the director does in the boardroom is substantially diluted.

Id.

One may further argue that the repealing of section 102(b)(7) may refresh the liability fear among corporate directors. Under this dissertation's proposal, the risk of liability exposure is minimized. It should be also noted that courts developed the business judgment rule over the years to protect directors from personal liability.[1243] Further, it is well-recognized that Delaware courts are very reluctant to impose monetary liability on directors for corporate losses resulting from an unsuccessful business decision.[1244] All of these factors should be sufficient to eliminate the fear of liability on the part of corporate directors. When a competent individual undertakes board service, she must assume the accountability attached to directorial authority.

At the end, what can this dissertation's proposal achieve? It can make a fiduciary claim based on "mere" inattentive conduct survive a motion to dismiss. It is unlikely that it would make a critical difference in substantive outcome. Nevertheless, it would require the defendant directors to justify their decision-making or oversight failures in a court room. Plaintiffs might not be able to make the defendant directors compensate corporate losses. However, they would be motivated to bring a lawsuit to discipline shirking directors and thereby protect the interests of the corporation in the long term. Indeed, the mere existence of litigation threat for due care failures would improve director attentiveness. The hope is that this dissertation's proposal would balance director authority and accountability without imposing personal liability on directors who act in good faith.

Thus, this dissertation proposes a reinvigoration of an enforceable duty of care along with *ex post* protection from monetary liability for good faith conduct. Under this approach, the duty of care would play an appropriate role in fighting board passivism. Most importantly, inattentive director conduct would be subject to judicial scrutiny at the instance of shareholders. By scrutinizing alleged due care claims under a lenient standard of gross negligence, courts would point out the decisional process or oversight failures in a particular factual setting and thereby inspire other directors not to repeat those mistakes in the future. Over time, these court opinions would delineate the specific requirements of the duty of care and help directors discharge their

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[1243] Compared to section 102(b)(7), this dissertation's proposal would be more consistent with the traditional business judgment rule analysis.

[1244] *See, e.g.,* Cox & Munsinger, *supra* note 1117, at 108 ("To the corporate lawyer, it is elementary knowledge that directors are seldom exposed to liability for business misjudgments and that courts only rarely, and with great reluctance, intrude into directors' business decisions."); Nowicki, *supra* note 1174, at 710 (noting Delaware courts' unwillingness to impose personal monetary liability on disinterested directors).

due care responsibilities properly. Accordingly, courts would telegraph to directors the expected conduct from them without the downside of actually imposing personal liability.

Of course, this dissertation's humble proposal does not claim to solve doctrinal and practical problems associated with the duty of care. It attempts to align two simple notions: the efficacy of the duty of care should be maintained, and directors should not face personal liability as long as they act in good faith. The duty of care has long been a controversial area of corporate law. Corporate scholars have extensively discussed the issue, and they are far from reaching a consensus. While all agree that directors should exercise their responsibilities attentively and on an informed basis, there is a great controversy regarding whether these objectives should rise to the level of an enforceable duty. Board inattentiveness or passivism is a complex problem. The duty of care alone may not be adequate to address this problem. At its heart, the duty of care relates to the quality of board service. It is difficult to articulate legal parameters to define and measure the expected quality of board service. In a broader context, this problem relates to corporate governance. While the fiduciary law is developed on a case-by-case basis by courts, corporate governance emerged on the federal level based on statutes and regulations. The federal regulations and authorities increasingly play an important role in establishing and promoting good corporate governance practices. The role of fiduciary duties and derivative lawsuits in corporate law has been significantly reduced. The fiduciary law served as an important monitoring mechanism in the nineteenth century when corporations emerged as large-scale, self-governing business entities. In the twentieth century, state legislatures increasingly relaxed the fiduciary standards and significantly constrained the scope of derivative action. State authorities' appetite to attract businesses for incorporation by creating a management-friendly climate may disable them from addressing the complex and systematic corporate governance problems. Derivative litigation may not be the best forum for shareholders to discipline inattentive directors. However, the importance of this traditional mechanism (fiduciary duties and derivative lawsuit) should not be underestimated. This mechanism is developed by judges over the years on a case-by-case basis, and its efficacy should be maintained.

CONCLUSION

The fiduciary duty of care requires directors to discharge their board responsibilities diligently, attentively, and on an informed basis. Section 102(b)(7) permits a certificate of incorporation to include a provision exonerating directors from monetary liability for a duty of care violation. A section 102(b)(7) provision forbids a shareholder from challenging "mere" inattentive director conduct, except for injunctive relief. In the post-exculpatory era, it is highly doubtful that the duty of care plays a meaningful role to control director behavior. Delaware courts' recent attempt to reinvigorate a liability threat for inattentive director conduct under the good faith doctrine was not fruitful. Section 102(b)(7) and its interpretation by Delaware courts virtually eliminate any threat of personal liability for fiduciary misconduct unless it involves conflicted directors who acted in their own interests or committed fraud or waste. This may not be adequate to address director inattentiveness. This dissertation proposes a reinvigoration of the duty of care along with *ex post* liability protection. Directors should not be afforded *ex ante* protection from monetary liability for a duty of care violation. The directors' due care failures should be subject to judicial review at the instance of shareholders. Where directors are found to have breached their duty of care, they should justify the challenged conduct in a courtroom on the basis of good faith in order to avoid monetary liability. This would both minimize the liability threat for directors who act in good faith and also encourage them to pay an increased attention to their board responsibilities. The symbolic existence of monetary liability and the threat of litigation would strengthen the directors' decision-making and oversight practices. Thus, this approach would promote both corporate risk-taking and compliant director behavior.

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