Section 40.1 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?

William J. Carney
Emory University Law School

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SECTION 4.01 OF THE AMERICAN LAW INSTITUTE'S CORPORATE GOVERNANCE PROJECT: RESTATEMENT OR MISSTATEDMENT?

WILLIAM J. CARNEY*

INTRODUCTION

The American Law Institute's (ALI's) corporate governance project has generated the most heated debate in the history of that distinguished institution. Critics claim that the document is a radical proposal for

* Of counsel, Long, Aldridge & Norman, Atlanta, Georgia (on leave as Charles Howard Candler Professor of Law and co-Director of the Law & Economics Program, Emory University. The author wishes to thank Professors Fred S. McChesney of Emory and Jonathan R. Macey of Cornell for their helpful comments on earlier versions of this paper, and John W. Spotts, Emory Law School, 1987, for his assistance with the research for this article. This article is based on a monograph prepared for the National Legal Center for the Public Interest, whose support is gratefully acknowledged. While this article is directed at questions of the proper role and liabilities of directors generally, it has implications for directors of closely held firms as well. It would unduly extend the article to discuss the particulars of those questions. I have previously argued that, the major problems of the closely held firm involve conflicts among co-owners over distributions and investments in the firm. Carney, The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure, 65 WASH. U.L.Q. 1 (1987). Others have also concluded that board decisions in closely held corporations are much more likely to involve questions of conflicts of interest among shareholders (and their directors) than more traditional business judgment questions. See, e.g., Peeples, The Use and Misuse of the Business Judgment Rule in the Close Corporation, 60 NOTRE DAME L. REV. 456 (1985).


2. Symposia discussing the project are listed infra note 66. T.D. No. 1; T.D. No. 2; T.D. No.
reforming corporate law in a way that increases legal intrusions into the management of business, while supporters claim that the document is fairly reflective of much of the existing law, and that it clarifies and simplifies that law. Because the two camps often seem to use (or are accused of using) different “modes of discourse,” reconciliation of their views often seems hopeless.

This article focuses on what thus far has been the most heated part of the debate—the ALI’s treatment of the duties and liabilities of corporate directors, set out in section 4.01 of the Principles of Corporate Governance. My thesis is, in part, like Seligman’s, that the project is a creature of its genesis, and that changing times and attitudes have led to different reactions to these proposals. Unlike Seligman, however, I ultimately agree with the critics that section 4.01 represents a change in the “real law” governing directors.

My thesis is that events of the 1960’s and ’70’s led to attempts by both corporate officials and their attorneys to fend off what they saw as radical law reform, focused on federal chartering, with a series of aspirational documents intended to reassure critics that corporate managers and their attorneys were good and responsible citizens who were aware of their responsibilities. Accepting Berle & Mean’s view of their own power,

3; T.D. No. 4; T.D. No. 5; T.D. No. 6, supra note 1. This criticism is not unique to the corporate governance project. Several years ago Professor W. Noel Keyes argued that the second series of Restatements had been transformed from faithful statements of existing law into reform documents, often without the candor to admit that their statements of governing law were contrary to prevailing rules. Keyes, The Restatement (Second): Its Misleading Quality and A Proposal for Its Amelioration, 13 Pepperdine L. Rev. 23 (1985). But see Wade, The Restatement (Second): A Tribute to its Increasingly Advantageous Quality, and an Encouragement to Continue the Trend, 13 Pepperdine L. Rev. 59, 83 (1985) (arguing that the Restatement (Second) has followed a practice of stating clearly in its comments or in the reporter’s notes when a minority position has been adopted as the black letter).

3. The initial reaction to the corporate governance project is traced in Keyes, supra note 2, at 43-45.


7. “Instead of demanding a better definition of the putative problem or attention to the distinctions among goals of particular reforms, they [representatives of the business community] have
corporate managers claimed the mantle of good citizenship that Berle had ultimately bestowed upon them.8

The articulation of these aspirations of responsibility created, for the first time, a dichotomy between legally oriented statements of proper conduct ("conduct rules"), and the rules under which courts had previously operated ("decision rules").9 When the ALI began its process of restatement, it was easy enough to seize upon the aspirational statements of behavior, the conduct rules, as if they were indeed the decision rules applied by the courts.

After briefly tracing this history, I will demonstrate how far the ALI has departed from existing law by examining the cases cited by the reporters for their statements of law. This review will demonstrate that the reporters have merged the decision rule into the recently developed conduct rule, thus fundamentally altering the legally applicable rules. I will conclude by examining the damage caused by such an approach, both in the context of particular judicial decisions and in the wider response of markets to announcements of these changes.

Part I begins with a brief recounting of the historical background of criticism of corporate law, and an examination of the development of the corporate governance project, its stated goals and the attitudes reflected in the tentative drafts. Part II argues that no legal support exists for the ALI's view of the role of the corporate board as a careful and independent monitor of potential law violations; indeed the ALI has built contradictory notions of the functioning of the board into its own statement of legal principles. Part III argues that the ALI's formulation of the directors' duty of care, while consistent with much dicta, imposes a stricter


"It is as though a large fraction of the community of business leaders wants to make preemptive concessions, as if they meet not to plan a fight against wrongheaded movement but to discuss how best to negotiate the terms of surrender." Id. at 525 (quoting Judge Robert Bork).

8. The seminal work is A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). Berle's view of managers as responsible and professional custodians for the public weal appears in A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION (1954). It has been observed by others how eager managers have been to adopt the mantle of "business statesmanship". See, e.g., Manne, The Higher Criticism of the Modern Corporation, 62 Colum L. Rev. 399, 413-14 (1962).

standard than the actual holdings support. Part IV argues that the standard of judicial review implicit in the ALI's formulation of the business judgment rule would inject judicial review far into corporate decision-making, where the judicial process is unsuitable. This approach reflects either a profound mistrust of corporate processes or a misunderstanding of the past function of the business judgment rule. Part V reviews recent legislation permitting insulation of directors from liability for their own negligence. This legislation, however, does not protect their decisions from judicial review.

I. THE ALI CORPORATE GOVERNANCE PROJECT: CONFUSION AND CONTROVERSY

The ALI's corporate governance project began in a period of populist criticism of American corporations. Observers vehemently disagreed about whether there was anything fundamentally wrong with America's system of corporate governance. Indeed, that disagreement extended to the role of the state in corporate law: was it a regulator or enabler of contracts? The ALI's approach to such a project would depend upon the identity of those heading the project, and their views on this question. After an initial attempt at conservative leadership was ended by an untimely death, the project was placed in the hands of reporters viewed by some as advocates of regulation. This characterization has led to vehement denials by the current reporter, who claims that the criticisms of the project are overdrawn. He maintains that the Reporters in fact support the enabling and contractarian view of the corporation, and seek only to save the corporation by providing legal rules to ensure the ac-


12. Compare Nader, TAMING THE GIANT CORPORATION, supra note 10, at 15-17, with Hessen, supra note 11, passim. The confusion is not limited to treatise writers. Compare Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) ("It is no more a state instrument than a natural person exercising the same powers would be" - Marshall, C.J.) with Hule v. Henkel, 201 U.S. 43, 74 (1906) ("[T]he corporation is a creature of the state. It is presumed to be incorporated for the benefit of the public. It receives certain special privileges and franchises, and holds them subject to the laws of the state and the limitations of its charter. Its powers are limited by law. It can make no contract not authorized by its charter.") (Brown, J.).

13. See text infra at note 58.
countability necessary to obtain legitimacy.\textsuperscript{14}

\textbf{A. The Background of the Corporate Governance Project}

The corporate governance project could be said to have its genesis in William L. Cary's famous "race to the bottom" article about the development of Delaware corporate law.\textsuperscript{15} As the president of the ALI has stated, during the 1970's corporations were under attack, and when federal intervention was being proposed, "[t]he importance of assuring a sturdy institutional framework for our free enterprise system" was apparent to many observers.\textsuperscript{16}

The history of corporate criticism in the late 1960's and 1970's is well documented, and need not be repeated here. Anti-war activists used corporate proxy machinery and the courts to lobby for their view of corporate social responsibility—which included termination of the manufacture of napalm for the government.\textsuperscript{17} Other activists joined with Ralph Nader in proxy campaigns to make General Motors more socially responsible.\textsuperscript{18}

The same critics who were urging "social responsibility" even at the expense of corporate profits, simultaneously claimed that a series of major corporate bankruptcies and fraud cases demonstrated that the current governance system was not even serving the narrow goal of shareholder wealth maximization.\textsuperscript{19} Some observers believed that corporate directors were largely at fault, remaining aloof and ignorant about corporate affairs, and passive in responding to management's proposed courses of action.\textsuperscript{20} The disclosures of questionable payments during the post-

\textsuperscript{14} Eisenberg, \textit{Modernizing Corporate Law}, supra note 4 at 628 and \textit{New Modes of Discourse}, supra note 4, at 589-90.

\textsuperscript{15} Cary, \textit{Corporate Law and Federalism: Reflections Upon Delaware}, 83 YALE L.J. 663 (1973), is cited by Schwartz, \textit{Introduction}, in \textit{Symposium on Federal and State Roles in Establishing Standards of Conduct for Corporate Management}, 31 BUS. LAW. 859, 863 (1976), which in turn was cited by Herbert Wechsler, then Director of the ALI, as the conference that persuaded him "that there were important problems in the field of corporate structure and governance that the Institute could fruitfully address..." Wechsler, \textit{Forward}, in T.D. No. 1, supra note 1, at vii.

\textsuperscript{16} Perkins, \textit{The Genesis and Goals of the ALI Corporate Governance Project}, 8 CARDOZO L. REV. 661, 664 (1987) [hereinafter \textit{Genesis}]. This article contains a more detailed history of the background of the ALI, and of the corporate governance project, than is presented here.

\textsuperscript{17} See Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), \textit{vacated as moot}, 404 U.S. 403 (1972).


\textsuperscript{19} See generally Seligman, supra note 4, at 329-330.

\textsuperscript{20} Id. at 330-36.
Watergate era were seized upon as evidence that directors were not even monitoring to make sure that corporations remained law-abiding.\textsuperscript{21} Cary's attack on Delaware corporate law, and the "race to the bottom," with its proposal for federal minimum standards of conduct, was only the opening volley in a mounting attack.\textsuperscript{22} Nader's proposals for federal chartering represented the ultimate flowering of that movement.\textsuperscript{23} These proposals called not only for outside directors to monitor managers, but also for monitoring that would benefit constituencies other than shareholders—employees, communities and consumers, to name a few. In the midst of this ferment critics attacked even the provenance of the Model Business Corporation Act, on the grounds that the membership of the ABA Committee on Corporate Laws was tilted toward corporate practitioners who represented management.\textsuperscript{24}

These pressures led to an awareness among corporate lawyers of what appeared to be a widespread—and was most certainly a highly vocal—discontent with the performance of corporate managers.\textsuperscript{25} In hindsight, one might speculate that this discontent was either no more than the anti-business bias that often exists in many people, or the particular attacks of those—largely academics—with their own agendas, rather than some wider and more focused concern on the part of the electorate.

These same pressures generated the Airlie House Conference of 1975, sponsored by the American Bar Association Section of Corporation, Banking and Business Law. At the Airlie House Conference questions of corporate legitimacy and control of corporate action were high on the agenda.\textsuperscript{26} Federal chartering seemed to be the preferred solution to a variety of ills described.\textsuperscript{27}

\textsuperscript{21} \textit{Id.} at 333-36.
\textsuperscript{22} Cary, \textit{supra} note 15.
\textsuperscript{23} Nader, Green \& Seligman, \textit{supra} note 10.
\textsuperscript{26} \textit{Symposium on Federal and State Roles in Establishing Standards of Conduct for Corporate Management}, 31 \textit{Bus. Law.} 861 (1976).
\textsuperscript{27} See, e.g., Jennings, \textit{Federalization of Corporation Law: Part Way or All the Way}, 31 \textit{Bus. Law.}
This was the setting for the Committee on Corporate Laws' efforts "to set forth a standard of care applicable to directors thus changing the policy of the original draftsmen of the Model act who believed that the standard of care for directors would more appropriately be found in the decisions of the courts . . . ."28 I now believe that the Committee's 1974 proposal, adopted in 1975, was a radical change in corporate law. The crucial language has been preserved in later versions of the Model Business Corporation Act. It reads:

All corporate powers shall be exercised by or under the authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors . . . .

. . .

A director shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.29

The Committee on Corporate Laws perhaps thought that the principal thrust of the revision of section 35 was to relieve directors of legal responsibility for the day-to-day management of the corporation.30 Ultimately, however, the language chosen to accomplish this became a tool for creating a new and active duty to monitor for corporate law violations.

In 1976 the ABA published the Corporate Director's Guidebook, which again addressed the question of the duties and liabilities of directors.31 That document expanded on the standards of care set forth in the 1975 amendments to section 35 of the Model Act. It stated that the "reason-

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30. The first sentence of section 35, which formerly read in relevant part: "The business and affairs of a corporation shall be managed by a board of directors . . . ." was amended as described supra text at note 29. Committee on Corporate Laws, supra note 28, at 949.

31. Subcommittee on Functions and Responsibilities of Directors, of the Committee on Corporate Laws, Section of Corporation, Banking and Business Law, American Bar Association, Corporate Director's Guidebook, 32 Bus. Law. 5 (1976). A revised edition was published by the full Committee on Corporate Laws in 1978, see infra note 99.
ably believes” language “establishes the objectivity of the standard governing director conduct . . . .” 32

Congressional Hearings held in 1976 and 1977 focused on various proposals to federalize corporate law. 33 Senator Metzenbaum’s opening remarks typified the mood of the hearings. After noting the large size of many corporations, the Penn Central bankruptcy, the sensitive payments made abroad, and the fact that some corporations are polluters, 34 he stated:

The time is ripe for full-scale exploration into what, if anything, the American people should be doing to make corporations more accountable to their stockholders and to the public. I am not here to say that all corporations are bad, because that is not true. Some far-sighted corporations and corporate lawyers have initiated some modest changes on their own. But the fact is that there is need for change. The only question left is how it is to come about. 35

At the 1976 Senate Hearings Professor Harvey Goldschmid, later reporter for Part IV of the corporate governance project, began his testimony by associating himself with Ralph Nader’s view that corporations were not being adequately regulated under state corporation laws. 36 His proposals for federal regulation included replacement of state laws with stricter federal fiduciary standards for directors, officers and controlling shareholders, establishment of governance provisions to assure corporate adherence to law; and establishment of a governance structure that would provide an independent board, capable of “checking” senior managers. 37

The onslaught continued into the 1980’s. Noting widespread doubts about the effectiveness of the corporate accountability processes, the SEC, under the chairmanship of Harold Williams, began a “corporate governance proceeding,” with nationwide hearings in 1977 and a final

32. CORPORATE DIRECTOR’S GUIDEBOOK, supra note 31, at 15.
34. A litany often recited by those sympathetic to federal chartering. See, e.g., Seligman, supra note 4, at 329-336.
35. 1977 Senate Hearings, supra note 33, at 2.
36. 1976 Senate Hearings, supra note 33, at 241.
37. Id.
report in 1980. Senator Howard Metzenbaum and Congressman Benjamin Rosenthal continued to propose legislation reflecting the agenda previously described—requirements for outside directors, nominating and audit committees, and definitions of directors' duties of care and loyalty. One part of the legislative reform package received approval: the Foreign Corrupt Practices Act of 1977, with its ominously vague command to corporate officials to implement monitoring mechanisms adequate to assure that sensitive payments do not go undetected.

The Business Roundtable joined the debate in 1977 with a symposium, which produced a summary published in 1978 in The Business Lawyer. The report focused on suggestions to improve the effectiveness of corporate boards, and thus answer concerns about accountability and legitimacy. Those recommendations were said to reflect present practice, and to provide "the optimum harmonization of corporate accountability with the decisiveness and flexibility of management . . . ."

The 1975 Airlie House Conference was followed by a series of regional conferences in 1977-78 that were jointly sponsored by the ABA section, the ALI, and the ALI-ABA Committee on Continuing Professional Education. These conferences apparently generated no consensus on the nature of the problems with corporate governance and structure that Herbert Wechsler, then Director of the ALI, claimed were the impetus for the corporate governance project. This result was hardly surprising, since a contemporary article by Bayless Manning identified nine dif-


41. The Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 BUS. LAW. 2083 (1978) [hereinafter The Role and Composition of the Board].

42. Id. at 2092-94.

43. Id. at 2094.

44. Wechsler, supra note 15, at vii-viii. For a critique that argues that these conferences failed to identify any "problems in the field of corporate structure and governance," see West, An Economist Looks at the ALI Proposals, 9 DEL. J. CORP. L. 638 (1984).

45. Wechsler, supra note 15; West, supra note 44.
fert species of answers to the question, "precisely what is it about
today's corporations or corporation law that seems to you so antisocial,
dangerous, or unjust?"46 Indeed, there were those participants who argued
that corporations were already quite legitimate, and that the ALI
was asking the wrong questions.47

B. Reform and Change in Corporate Law

In 1978 the Council of the ALI voted to begin a corporate governance
project.48 Roswell Perkins, President of the ALI, described the primary
motivations behind this action as securing public confidence for business
corporations (legitimacy) and clarifying existing law.49 Others have de-
scribed it more dramatically, citing, in addition to the federal chartering
proposals, the "ominous presence of Senator Howard Metzenbaum, Con-
gressman Benjamin Rosenthal, and some benign outside agitators like
Mark Green and Ralph Nader, and others who were suggesting much
more radical proposals."50 In the words of Donald Schwartz, "if all
those ideas were to be rejected . . . then there was a need to strengthen
internal mechanisms within the corporation. And that's why the initial
focus was on corporate governance . . . . It was not to manage the corpo-
ration, but to increase monitoring . . . ."51

Another account suggests the influence of Professor Louis Loss on the
shape of the project at the initial discussion stage:

It was Professor Loss who suggested what kind of project it should be when
he said that the Project should not be the usual restatement, because so
much of corporate law is not restatable. But there was certainly the possi-
bility of restating substantial parts of corporate law that were essentially
common law in origin; officers' and directors' duties, and the remedies for
enforcing those duties.

By restatement, Loss did not mean just taking the rule that the plurality
of jurisdictions follows. He meant selecting the best and most forward
looking rules, a process which is typical and traditional for an ALI

47. P. Aranson, A Political Economist's Perception: Corporations Are More Legitimate Than
Government, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 81 (D. Schwartz,
ed. 1979) [hereinafter COMMENTARIES].
49. Id. at 667.
51. Id.
The original goals of the corporate governance project were stated by Herbert Wechsler in the forward to the First Tentative Draft, which appeared in 1982:

There were strong indications at the conferences [referred to above] of professional support for Institute examination of the field, with substantial preference for an approach that would encompass both restatement and recommendations for improvement in prevailing law or practice.

When this point had been reached, the Council invited Ray Garrett, Jr., ... to define a project, if any that he thought the Institute should undertake. Responding in May, 1978, Mr. Garrett recommended a program consisting, initially, at least of 'a restatement with recommendations regarding the legal duties incident to corporate management and control.'

To this date it can be argued that the goals of the project remain unclear. While Professor Loss wished for the project to provide the "best and most forward looking rules," his colleague, Robert Clark, later viewed the project as doing little more than restating majority rules. The ALI's president, Roswell Perkins, on the other hand, viewed it as designed to "preserve and enhance the effectiveness of corporations," and to clarify corporate law. Clarification could be characterized as a stronger specification of the property rights of various actors in the firm. Such clarification is at odds with the emphasis on greater judicial review of corporate decisions that seems likely under the ALI's proposals. Professor Christopher Stone, a self-described reformer, recently elucidated the difficulties with a general goal such as "legitimacy": "Talk about legitimacy, because it is safely abstract and 'high-falutin', only distracts

52. Id. at 688.

53. Wechsler, supra note 15, at viii. Professor Wechsler went on to quote from Mr. Garrett's explanation of his intentions:

Where there is no judicial authority, or where the cases are unsatisfactory by modern standards—either because of their antiquity, or the absence of compelling analysis, or because today they just seem wrong—resort must be had to other sources. These may include the literature on the subject, the better corporate practice in the view of those experienced in the field, not limited to lawyers, and ultimately the judgment of the Institute, aided by the Reporter and his Advisers. Where the project is in fact restating the cases, the Institute's views should take the form of recommendations, which may include recommended statutory provisions, state or federal.

Id.


from the real issues."\(^{57}\)

Given the lack of consensus about the nature of the project, selection of reporters was crucial to its ultimate direction. Ray Garrett was selected as the Chief Reporter for the project, but the work had barely begun when he died in February, 1980.\(^{58}\) After Mr. Garrett's death those appointed as reporters generally have been identified with the law reform proposals described above. George Birrell described the reporters now responsible for the provisions concerning duties and liabilities of directors in the following terms:\(^{59}\)

Professors Melvin A. Eisenberg (now the Chief Reporter), Harvey J. Goldschmid, and John C. Coffee, Jr. all had concluded publicly that the then existing corporate governance system was broken and in need of repair. Professor Eisenberg was a particularly strong proponent of the 'monitoring' model for boards of directors and the need for total director independence from management.\(^{60}\) Professor Goldschmid had espoused a more precise definition of board responsibilities, emphasizing the duty of checking on management combined with new remedies and penalties to enforce those duties.\(^{61}\) Professor Coffee had expressed similar views in a 1977 law review article\(^{62}\) and then in 1981 proposed a model act relating to derivative actions which would facilitate their initiation, make them more difficult to terminate, and provide greater incentives to plaintiffs' counsel to maintain the actions.\(^{63}\)

The response of the bar and the corporate community to the First Tentative Draft was unprecedented.\(^{64}\) The Business Roundtable took the unusual step of addressing the project. It complained that rather than

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59. Birrell, Forward, The American Law Institute and Corporate Governance: An Analysis and Critique at vii-viii (1987). [Footnotes are taken from the quoted material, but are renumbered here.]
60. M. Eisenberg, The Structure of the Corporation 168 (1976); Eisenberg, A Larger Role for Shareholders, in COMMENTARIES, supra note 47, at 133, 136.
64. Perkins, Genesis, supra note 16, at 669, described it as having "aroused cries of alarm in the business world," which he attributed to "insufficient understanding of where the law of business corporations already stood." He cited H. BALLANTINE, LAW OF CORPORATIONS (rev. ed. 1946) in support of his claim that the law was already as T.D. No. 1 suggested. Id. at n.22. This article takes

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carefully distinguishing between restatements of existing law and reform proposals, "[t]he Reporters instead had created a homogeneous document, in which all black letter rules . . . start with the same phrase, ‘corporate law should provide.’" Law journal symposia proliferated, and at one of them Stanley Kaplan, then Chief Reporter, noted that the reaction had been “extraordinary.” His successor, Professor Melvin Eisenberg, found it necessary to engage in the *ad hominem* tactic of characterizing the critics of the project as “Manicheans” who divide the debate over corporate law into two schools—the forces of Light and the forces of Darkness. In the Second Tentative Draft, which appeared in 1984, Herbert Wechsler referred to the “fiery rhetoric aroused by Tentative Draft No. 1 . . . .” In response, the title of the document was changed to “Analysis and Recommendations,” and the phrase “corporate law should provide” was deleted. As Professor Wechsler took pains to explain, the new format “makes clear, it is believed, that all statements concerned with law should be regarded as recommendations of the Institute . . . .” He defended the law reform nature of the project, stating that “[t]he Restatements, important as they are, never have been viewed as the exclusive means for the pursuit of our objectives: the clarification and simplification of the law and its better adaptation to social needs.” In support of his assertion, he listed numerous projects such as the Uniform Commercial Code and other codes that had been undertaken, largely during his tenure as Director. Professor Wechsler assured readers that there would be no blurring of true restatements and recommendations for law reform, because of “the context and the explanation in

the position that Professor Ballantine erred in his description of the duty of care. See infra text accompanying notes 144-72.


67. Eisenberg, *New Modes of Discourse*, supra note 4, at 587. For a reply, see Baysinger & Butler, *Reply, supra note 4*.

68. T.D. No. 2, supra note 1, at ix.

69. Id.

70. Id. at ix-x.
the Comment making clear how far a recommendation is believed to be consistent with prevailing law and how far legal change is contemplated . . . ."\(^{71}\)

By 1988 the ALI may regard the corporate governance project as something of a tar baby. In 1985 it was necessary to seek an additional $500,000 for the project, which was granted by the MacArthur Foundation.\(^{72}\) The ALI's president Perkins noted that the project had proved to be "far more difficult and far more controversial than anticipated when it was commenced."\(^{73}\) Indeed, one of the most difficult areas, involving transactions in control, has not yet been the subject of a tentative draft, indicating how far the ALI has yet to travel.\(^{74}\)

C. An Overview of the ALI View of the Duties and Liabilities of the Board

The ALI's proposals concerning the role of corporate directors have generated the greatest controversy. The role of shareholders, and of the market for corporate control, have received relatively little attention so far. This is consistent with a view that directors are the dominant actors in corporate governance, and are thus far not held effectively accountable to shareholders or to other constituencies of the corporation.\(^{75}\)

Central to the ALI's proposals are rules governing the nature and extent of the monitoring role of the board of directors. The early drafts emphasized this with legal requirements concerning the use of outside directors and monitoring committees, that have since been modified to become mere recommendations of good corporate practice.\(^{76}\) But the

\(^{71}\) Id.

\(^{72}\) Perkins, The President's Letter, 3 ALI REPORTER 1-7 (April, 1985).

\(^{73}\) Id.

\(^{74}\) Professor Ronald Gilson has been named as co-Reporter along with Marshall Small, for Part VI, Transactions in Control. At this date a preliminary study of issues involved has been produced. Principles of Corporate Governance: Analysis and Recommendations - Reporters' Study No. I - Transactions in Control, ALI (1985). Various informal drafts of Part VI have been circulated for review by the ALI Council, but they have not yet been published for a wider audience.


\(^{76}\) The ALI's current proposal has partially abandoned its earlier requirement that boards of publicly owned companies should be dominated by so-called "independent" directors. Section 3.03 of T.D. No. 1, supra note 1, required that the boards of large publicly held corporations should be composed of at least a majority of directors who were "free of any significant relationships with the corporation's senior executives . . . ." T.D. No. 2, supra note 1, § 3.04, reduced that to a recommen-
ALI's vision of the role of the corporate board has not changed. The Reporters still envision the board as a monitor—as a watchdog to assure that corporate employees behave lawfully and responsibly.\(^7\) That vision, buttressed by statements of the duty of care of boards that do not correspond with either past or present legal reality, imposes burdens on corporate boards not previously required by American law.

The ALI suggested a vigorous monitoring role for a board dominated by directors without any particular stake in the corporation's success.\(^8\) At the same time, the ALI created a paradox by recognizing the need for modern boards to delegate many of their functions to hired managers—the very persons the board is expected to monitor.\(^9\) No attempt is made to explain how an outside board, unfamiliar as it must be with the internal working details of a large corporation, can expect the very employees it must monitor to assist it in the monitoring function.

The duty of care imposed by the ALI, that of an ordinarily prudent person in like circumstances, is consistent with other recent formulations of the rule. However, the recent formulations, with their aspirational language, a product of the 1970's, come in conflict with the holdings of virtually all the decided cases.

The ALI's formulation of the business judgment rule does not capture the deference generally granted to directors. This deference is best evidenced by the almost total absence of decisions holding directors liable for breaches of the duty of care in connection with affirmative decisions (as opposed to total inattention and neglect). As the most prominent scholarly work in the field has suggested, it may be more accurate to state the rule as one of gross negligence.\(^10\) The ALI's approach merges

\(^7\) T.D. No. 2, supra note 1, § 3.02(a)(1), provides that it is the function of the board to "oversee the conduct of the corporation's business with a view to evaluating, on an ongoing basis, whether the corporation's resources are being managed in a manner consistent with the principles of § 2.01 . . . ." T.D. No. 2, supra note 1, § 2.01(a), unlike any statement of the objectives of a corporation currently found in U.S. statutes, provides that a business corporation "is obliged, to the same extent as a natural person, to act within the boundaries set by law." The most recent formulation of the duty of care to monitor for law compliance is found in T.D. No. 4, supra note 1, § 4.01.

\(^8\) \textit{See supra} note 76.

\(^9\) The power of boards to delegate is set out in T.D. No. 4, supra note 1, §§ 4.01(b) and 4.02 - 4.03, discussed \textit{infra} text at notes 124-26.

\(^10\) Bishop, \textit{Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers}, 77 \textit{Yale L.J.} 1078, 1101 (1968) ("All in all, I remain very skeptical of the proposition that directors of industrial corporations run any substantial risk of liability for ordinary negligence.")
the business judgment rule into the stricter and more aspirational statements of the duty of care, by making compliance with the duty a prerequisite to the shelter of the rule. Where the board must make affirmative decisions, the ALI would provide the shield of the business judgment rule only where the courts had scrutinized, after the fact, whether the director had assembled sufficient information on which to make a decision. Sufficient information means, in the words of the ALI, when "he reasonably believes" that he is sufficiently informed to the extent appropriate under the circumstances. This approach admits only in the most extreme cases that the process of deciding how much information is required for a decision is itself a business judgment, entitled to the protection of the rule.

Finally, under the ALI's approach, the validity of the decision itself is tested under a "rational basis" test that departs from the more liberal formulations generally used by the courts. In short, both the process of making a decision and the decision itself will be subject to review after the fact, contrary to past judicial practice. In the words of the ABA, it provides an objective test of the directors' decisions. The mischief possible in such an approach is already being demonstrated in the courts.

D. The Consequences of the ALI's Proposals

Hints of judicial acceptance of the changes suggested by the ALI, coupled with other forces, have disrupted corporate practices. Increases in liability insurance premiums for officers and directors have created a furor. In some cases the unavailability of insurance has led to widespread resignations of outside directors. In the ultimate irony, these factors have led to widespread legislative action, rejecting the very rules of liability the ALI Reporters have urged. As a result, the ALI standards appear irrelevant even before their final adoption.

81. T.D. No. 4, supra note 1, § 4.01(c)(2).
82. Section 4.01(c)(3) of T.D. No. 4 phrases the test in terms of whether the director "rationally believes" the business judgment is in the best interests of the corporation, while T.D. No. 1 and T.D. No. 4, supra note 1, § 4.01(d)(3) phrased it in terms of whether the director had a "rational basis" for such beliefs. For convenience I shall refer to this as the "rational basis" test, regardless of the draft being discussed.
83. Corporate Director's Guidebook, supra note 31, at 15.
84. See infra part III.D.
II. The Monitoring Role of the Board of Directors

Here, as in the following two sections, I examine the ALI's claims about the state of existing law in light of the statutes and cases cited by the Reporters. Proving the negative of a proposition remains an impossible task, so I only argue that if the Reporters were unable to find any authority to support their claims, it is highly improbable that any such authority exists. If proponents of a statement of the law must bear the burden of proof, the Reporters have clearly failed in their task.

A. The Monitoring Function—A New Role?

1. The ALI's Approach

The requirement that directors monitor corporate officials for law compliance is one of the major reforms introduced by the ALI project.\(^ {85} \) Section 3.02 provides that the board must oversee corporate conduct with a view to evaluating, "on an ongoing basis, whether the corporation's resources are being managed in a manner consistent with the principles of section 2.01", which includes the obligation to "act within the boundaries set by law."\(^ {86} \) Further, as section 4.01(a)(1) points out, "[t]his duty includes the obligation to make ... such inquiry as the director or officer reasonably believes to be appropriate under the circumstances."\(^ {87} \) The official comments cite no law for this obligation, but instead cite only the aspirational language of the ABA's Corporate Director's Guidebook. The Guidebook states that "the corporate director should be concerned that the corporation has programs looking toward compliance with applicable laws and regulations ... and that it maintains procedures for monitoring such compliance."\(^ {88} \) Rather than identify this as a law reform proposal, the official comment begins by conceding that it differs from the statutory formulations of the board's role, "but [it] provides an articulation of basic functions and powers which almost certainly would be arrived at by the courts in light of the language of these statutes, read in the context of modern corporate prac-

\(^ {85} \) This does not ignore the requirements of the Foreign Corrupt Practices Act of 1977, supra note 40. That act requires monitoring only in the limited area of certain payments to foreign officials, rather than more general monitoring for compliance with all laws.

\(^ {86} \) T.D. No. 2, supra note 1, § 3.02(a)(2).

\(^ {87} \) T.D. No. 4, supra note 1, § 4.01(a)(1).

\(^ {88} \) T.D. No. 2, supra note 1, § 3.02 comment d, at 69. Veasey, New Insights Into Judicial Deference to Directors' Business Decisions: Should We Trust the Courts?, 39 BUS. LAW 1461, 1465 (1984), also characterizes these statements as aspirational.
tice.” 989 Ironically, the statutes cited are those, such as the Model Act and Delaware, that were amended to excuse directors from direct management, rather than to impose a monitoring duty on them. 990

This language “requires a director or officer to use reasonable care with respect to his corporation’s obligation to obey the law.” 991 The cases cited in support of the monitoring obligations of directors under section 4.01(a) provide no support for a monitoring obligation. Instead the cases support only a rule that directors may not participate in corporate activities that violate the law—in short, that they may not be active participants in law violations. 992 The more controversial proposition is that of section 4.01(a)(1), which imposes a duty of reasonable inquiry to assure that law violations do not occur. The official comments indicate that “the ‘inquiry’ concept set forth in section 4.01(a)(1) is generally recognized in the case law and by commentators.” 993 It is revealing that the reporters cite no cases at this point.

Turning to examples of “reasonable inquiry in appropriate circumstances”, the official comments attempt to give examples of the duty to monitor. The comments assert that “[t]he board’s oversight and reasonable inquiry obligations should be interpreted to include an affirmative obligation of directors to be reasonably concerned with the existence and effectiveness of programs or procedures to assist the board in overseeing the corporation’s business.” 994 And later: “the affirmative establishment and maintenance of law compliance programs is widely accepted business practice today.” 995

The only case cited on the duty to monitor for law compliance is directly contrary to the assertions concerning existing law. In *Graham v. Allis-Chalmers Manufacturing Co.*, the Delaware Supreme Court, in the words of the Reporters, “seemed to envision a passive role for the board, at least with respect to one kind of oversight program, a law compliance

89. T.D. No. 2, supra note 1, § 3.02, comment a, at 67.
90. See infra text accompanying notes 121-22.
91. T.D. No. 3, supra note 1, § 4.01(a), comment, at 19-20.
92. Id. at 19-22, citing Abrams v. Allen, 297 N.Y. 52, 55-56, 74 N.E.2d 305, 306 (1947); Wilshire Oil Co. v. Riffe, 409 F.2d 1277, 1283-86 (10th Cir. 1969); Di Tomasso v. Laverro, 250 A.D. 206, 209, 293 N.Y.S. 912, 916-17, aff’d mem., 276 N.Y. 551, 12 N.E.2d 570 (1937) and Miller v. AT&T, 507 F.2d 759 (3d Cir. 1974).
93. T.D. No. 4, supra note 1, § 4.01(a)(1) - (a)(2), comment c at 43; see also T.D. No. 3, supra note 1, § 4.01(b), comment, at 42 (“the law is settled with respect to the ‘reasonable inquiry’ obligation.”)
94. T.D. No. 4, supra note 1, at 47.
95. Id. at 49.
program.” 96 The notes quote the Delaware Supreme Court’s opinion to the effect that there is “no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists . . . .” 97

In rejecting the reasoning of the Allis-Chalmers opinion, the comments of the Reporters note that the opinion is over twenty years old, and that the obligation component of the duty of care “is a flexible and dynamic concept.” 98 No cases are cited to demonstrate a contrary rule. The comments cite only the aspirational language of the Corporate Director’s Guidebook, an article by one of the reporters and one other article. 99 Does this mean that the law has somehow changed without further decisions, or that the Allis-Chalmers case was an aberration when decided, being from a state engaged in a “race to the bottom”? 100 A close examination will show that the Allis-Chalmers case was good law at the time of the decision, and remains so today.

2. The Pre-Allis-Chalmers Law

Prior law on the duty to monitor for law compliance supports the Allis-Chalmers rule. It is based on the not unreasonable assumption that directors are busy people who must, of necessity in large enterprises, rely

96. Id. at 47-48 (citing Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963)).
97. Id. at 48 (quoting 41 Del. Ch. at 85-86, 188 A.2d at 130-31).
98. T.D. No. 4, supra note 1, at 48.
99. Id. at 48-49, (citing American Bar Association, Section of Corporation, Banking and Business Law, Committee on Corporate Laws, The Corporate Director’s Guidebook, 33 Bus. LAW. 1591 (1978) [hereinafter The Corporate Director’s Guidebook]); The Role and Composition of the Board, supra note 41; Small, The Evolving Role of the Director in Corporate Governance, 30 HASTINGS L.J. 1353, 1360-61, n.35 (1979) and Veasey & Manning, Codified Standard—Safe Harbor or Uncharted Reef?, 35 Bus. LAW. 919, 930 (1980). The comments concede that “[t]he Corporate Director’s Guidebook and the Business Roundtable Statement [The Role and Composition of the Board, supra note 41] were intended as corporate practice recommendations rather than as rules of law.” T.D. No. 4, supra note 1, at 49. The article by Small makes no claims about a legally imposed duty to monitor for law violations; it only addresses the obligations of directors where wrong-doing has been called to their attention. The article by Veasey & Manning notes the The Role and Composition of the Board, supra note 41, and states that “If this statement tells us about what an ‘ordinarily prudent person . . . in a like position . . . under similar circumstances’ would do by suggesting that directors of large corporations are expected to install . . . compliance systems,” then hypothetical directors facing a situation similar to that of directors in the Allis Chalmers case “may well be liable for their failure to do so.” 35 Bus. LAW. at 930. The authors do not assert, however, that the The Role and Composition of the Board is indeed a statement of fact about current practices.
on the honesty and integrity of the agents chosen to run the business, at least until facts are called to their attention that require further investigation. In short, no monitoring duty existed prior to Allis-Chalmers. Only one case appears to be directly on point, and it, too, involved antitrust violations. District Judge Wyzanski instructed a jury that officers of corporations who take no part in a violation are not liable for it.101

Other cases addressing questions of monitoring involved not corporate criminal acts, but criminal acts by corporate employees, such as theft from the corporation. While not directly on point, they illustrate the settled judicial view of the duties of directors, and directors’ entitlement to assume honesty on the part of corporate employees.

American law on the monitoring duties of the board began with Briggs v. Spaulding, in which directors were sued in connection with a bank failure caused by employee thefts.102 Nearly all of the assets of the bank were stolen by the time of discovery in a type of fraud that was novel for the time. In holding that the non-officer directors were not liable, Chief Justice Fuller quoted with approval from Spering’s Appeal, which held that directors have no duty to monitor.103

The opinion also quoted English authority for the proposition that no monitoring duties were imposed on directors.104 It then refused to impute knowledge of all corporate records to the directors, noting that di-

101. [If] an individual who was an officer of a corporation has no connection with the action of the corporation on a particular matter except he happens to be an officer, he is not personally liable under this statute or in this complaint. To be liable an individual must either himself participate or must authorize another to act or must with knowledge of the responsibility acquiesce in the act of another with which he is affiliated as an officer or in a like relationship.


103. Upon a close examination of all the reported cases, although there are many dicta not easily reconcilable, yet I have found no judgment or decree which has held directors to account, except when they have themselves been personally guilty of some fraud on the corporation, or have known and connived at some fraud in others, or where such fraud might have been prevented had they given ordinary attention to their duties.

141 U.S. at 148-49 (citing Spering’s Appeal, 71 Pa. 11 (1872)).

104. ‘I know of no law,’ said Vice-Chancellor McCoun, in Scott v. Depoyster, 1 Edw. Ch. 541, 6 L. ed. 239, ‘which requires the president or directors of any moneyed institution to adopt a system of espionage in relation to their secretary or cashier or any subordinate agent, or to set a watch upon all their actions. While engaged in the performance of the general duties of their station, they must be supposed to act honestly until the contrary appears; and the law does not require their employers to entertain jealousies and suspicions without some apparent reason.’

141 U.S. at 162.
rectors must trust the affairs of the corporation to corporate officers and "agents in whom they have confidence, and [must] largely trust to them."\(^{105}\)

This rule continued at least until the decision in *Graham v. Allis-Chalmers*. The treatises of the time clearly state the same rule. Professor Hornstein stated the rule in 1959:

[A director] is expected to delegate responsibilities to officers (and agents), and he is not an insurer of their fidelity; but he does become chargeable with ensuing losses which result either from lack of care in the appointment or from failure of supervision (e.g., suspicious circumstances which would have caused an ordinary business man to take action.)\(^{106}\)

A special set of cases involving bank directors suggests that some monitoring duty exists at least where a reasonably attentive director would have been placed on notice that something was wrong.\(^{107}\) But at the time of the Delaware Supreme Court's decision in *Allis-Chalmers* it clearly represented the prevailing (indeed universal) rule: directors owe no duty to monitor for law compliance, absent particular notice of wrong-doing.

3. *The Post-Allis-Chalmers Law*

The ALI approach appears to depend not on reported judicial decisions, but upon assertions concerning changing management practices. If standards of conduct are to be tied to those observed by ordinarily prudent persons in like positions and in similar circumstances, has the legal duty changed because of changing corporate practices? Under these circumstances "good corporate practice" becomes the norm, not only the conduct rule but also the decision rule. In order to provide legal advice, corporate counsel will need to inform themselves not only about judicial decisions, but also about the practices of boards of directors throughout the nation. In support of their assertion about changing practices, the Reporters cited only the *Corporate Directors' Guidebook* and the Business Roundtable's summary of its symposium on *The Role

\(^{105}\) Id. at 163.

\(^{106}\) G. Hornstein, 1 *CORPORATION LAW AND PRACTICE* 446, 566 (1959). See also N. Lattin, *LATTIN ON CORPORATIONS* 247 (1950):

In supervising the business, directors may rely upon reports of their officers as to the progress being made by their corporation, its financial condition, its probable earnings and a host of other things upon which tabs should be kept but about which no director would be expected to do the leg-work.

\(^{107}\) Lattin, *supra* note 106, at 247-48. See also the *Corporate Director's Guidebook*, *supra* note 99, at 11, ("there are special statutory standards of responsibility and liability applicable to the banking director").
and Composition of the Board. The Reporters claimed that "they reflect the fact that the affirmative establishment and maintenance of law compliance programs is widely accepted business practice today." This assertion ignores the fact that both documents were aspirational and not empirical, and both were written at a time of attack on the corporation, which influenced their content. As Professor Kenneth Andrews later complained, the Reporters were either ignorant of the wealth of literature about the actual functioning of boards, or they ignored it. The evidence (consisting of the lack of judicial decisions that cite widespread monitoring practices by prudent directors, and the SEC's difficulties in rule-making to implement the limited monitoring duties imposed by the Foreign Corrupt Practices Act) strongly suggests that corporate practices may have changed little since Allis-Chalmers, despite exhortations by the groups mentioned above.

There are no judicial decisions since 1963 that question, criticize or deviate from the rule so firmly established by the time of the Allis-Chalmers decision. In a variety of settings the Delaware courts have reaffirmed the basic rule of Allis-Chalmers—that directors are entitled to rely on the reports and good faith of officers and agents of the company—even in the context of charges of illegal corporate lobbying payments.

The courts of other jurisdictions have also cited Allis-Chalmers with approval. Perhaps the most impressive support for the rationale of Allis-Chalmers comes from a decision refusing to hold directors liable under the federal securities laws for the fraud of corporate officers. In Lanza v. Drexel, investors attempted to hold directors liable for their failure to discover that certain officers of the company had falsified its financial records by overstating sales, backlogs and profits—a criminal

108. T.D. No. 4, supra note 1, at 49.
109. See, e.g., The Role and Composition of the Board, supra note 41, at 2101:
Some recent lapses in corporate behavior have emphasized the need for policies and implementing procedure on corporate law compliance. These policies and procedures should be designed to promote such compliance on a sustained and systematic basis by all levels of operating management.
act.\textsuperscript{113} In a scholarly opinion, Circuit Judge Moore held that an outside director and a partner in the underwriting firm was not liable for his failure to monitor and detect the frauds. No requirement existed at common law that directors monitor for fraud at the time of the adoption of the Securities Exchange Act, either in England or the United States. The English rationale, expressed in a suit against bank directors, was the same as the American, according to the opinion:

I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.\textsuperscript{114}

The opinion also quoted with approval Judge Learned Hand's landmark opinion in \textit{Barnes v. Andrews}, where an outside director was exonerated from responsibility for the fraud of corporate employees in a securities offering. Judge Hand wrote that the director "might assume that those who prepared [the offering documents] would not make them fraudulent."\textsuperscript{115}

This remains the federal rule under the securities laws to this day—that directors are not liable for a negligent failure to supervise and monitor for fraud, but only for their own intentional or reckless acts in connection with an offering.\textsuperscript{116}

Where it appears appropriate to impose a duty to monitor corporate employees more carefully, special statutes have generally been adopted. In the special circumstances of a registration statement section 11 of the Securities Act of 1933 explicitly imposes a duty of due diligence upon each director to ascertain that the prospectus contains no fraudulent misstatements or omissions.\textsuperscript{117}

Similarly, when foreign payments by corporations appeared to create problems in international relations, it was necessary for federal law to require a monitoring duty. The Foreign Corrupt Practices Act now expressly requires corporations to "devise and maintain a system of internal accounting controls" sufficient to monitor for compliance with the

\begin{itemize}
\item \textsuperscript{113} Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc).
\item \textsuperscript{114} 479 F.2d at 1292 (quoting Dovey v. Cory, [1901] A.C. 477, 485-86).
\item \textsuperscript{115} 479 F.2d at 1292 (quoting Barnes v. Andrews, 298 F.2d 614, 620 (S.D.N.Y. 1924)).
\item \textsuperscript{116} \textit{Cf.} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
\item \textsuperscript{117} Securities Act of 1933, § 11, 15 U.S.C. § 77k (1982).
\end{itemize}
board’s authorizations.\textsuperscript{118} Without that requirement, it is clear that no express duty exists to monitor for illegal acts of employees. Even with that statute, the cases to date generally have involved outrageous illegal acts that have been brought to the attention of the board, and in which some directors were active participants, rather than simple failures to monitor.\textsuperscript{119}

In sum, the law has consistently held that directors are entitled to rely upon corporate officers who they appoint, both for their honesty and competence, until the directors have reason to believe that the officers are no longer behaving honestly or competently. This rule was considered fully justified in a simpler era; as business has grown in size and complexity the justification has become even stronger. To impose a greater monitoring duty on directors for law compliance seems to extend the Foreign Corrupt Practices Act to compliance with all laws—a drastic step for American law.

Even prominent critics of the American Corporation such as Christopher Stone have declined to impose liability on top corporate officials for corporate crimes. Stone concedes that most top level officials “are not likely to be familiar enough with wrongful corporate activities to be tainted with the mental states and actions that, combined, comprise the elements of various crimes.”\textsuperscript{120}

\textbf{B. The Paradox of the Delegating Board}

Rather than imposing stricter duties of personal knowledge and supervision on directors, the modern trend has been to expand the permissible reliance of directors on others. The American Bar Association reflected this trend in its 1974 changes in the Model Business Corporation Act. To recognize that directors of large publicly held corporations often remove themselves from direct management, section 35 of the Model Act

\begin{footnotes}
\footnote{120. Stone, \textit{Where the Law Ends}, 60 (1975). \textit{But see} Stone, \textit{Response, supra} note 57, at 836 (criticizing state laws that permit executives to be indemnified for fines paid for law violations so long as the executive had no reason to believe that the conduct was unlawful).}
\end{footnotes}
was amended to place the exercise of management powers "under the direction" of the board, rather than "by" the board. Section 35 was also amended to provide not only an explicit statement of the standard of care of directors, but also protection for directors who reasonably rely on information, opinions, reports and statements of others. The list of those on whom directors can rely is extensive—officers, employees, outside experts, including counsel and accountants, and committees of the board. In explaining the expansion of the right of reliance beyond the previously authorized area of dividend declarations, the ABA Committee on Corporate Laws stated:

In view of the persistent increase over the years in the complexity of corporate affairs, and hence in the number and complexity of the matters which directors must consider, retention of any limitation upon the right of reliance to specified categories of director actions is felt no longer warranted.

That trend has been recognized in the ALI project. The duty of care and monitoring standards of section 4.01 are qualified by the board's right to delegate, set out in section 4.01(b). However, instead of recognizing the right to delegate in good faith, the ALI's commentary turns it on its head, and creates a duty to monitor. The official comments to section 3.01 include a brief reference to the provisions of section 35 of the Model Act, which call for exercise of corporate powers "by or under the authority of . . ." and management of the business "under the direction of . . ." the board. This is followed by a quick move to the aspirational statements of the Corporate Director's Guidebook and the Business Roundtable statement, concerning the monitoring functions that boards can perform in the absence of direct involvement in the business. What the project fails to recognize is that the cases supporting the right of boards to delegate and to rely on their employees are precisely the cases that excuse ignorance of directors with respect to corporate wrongdoing.

Permission to delegate thus becomes a duty to monitor, in the

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121. American Bar Association, MODEL BUSINESS CORPORATION ACT ANNOTATED, § 35, 1 (1977 Supp.), as reported in Report of Committee on Corporate Laws, supra note 29, at 502. This has been preserved in REVISED MODEL BUSINESS CORP. ACT, § 8.01(b) (1984).

122. Report of Committee on Corporate Laws, supra note 29, at 502. This has been preserved in REVISED MODEL BUSINESS CORP. ACT, § 8.30(b) (1984).


124. T.D. No. 4, supra note 1, § 4.01(b).

125. T.D. No. 2, supra note 1, § 3.01, Comment, at 61-62.

126. T.D. No. 4, supra note 1, § 4.02 Reporter's Note 2, at 85.
ALI's view.

The conflict between the extent of delegation necessary for a board of outside directors to function in a large and complex business enterprise and the duty to monitor suggested by the ALI is best exemplified by the difficulties the Securities and Exchange Commission faced in enforcing the monitoring duty imposed by the Foreign Corrupt Practices Act.\textsuperscript{127} At one time the SEC proposed rule-making to specify the nature of the monitoring duties.\textsuperscript{128} The SEC abandoned that attempt in favor of a case-by case ex post attempt to determine what amount of monitoring, and what kind of monitoring systems, can be reasonably expected of modern corporations.\textsuperscript{129} Thus far the results have not been encouraging.\textsuperscript{130} Despite this, ALI president Perkins maintains that recognition of the boards' inability actively to supervise senior executives coupled with imposition of a monitoring duty has "materially advanced clarity of analysis" and has left directors "better off in the long run . . . ."\textsuperscript{131}

III. THE DUTY OF CARE

This section examines the conduct rules governing directors' duty of care. The conduct rule has always been general and open-textured in the extreme. Indeed, it possesses elements of circularity by referring to standards of care observed by ordinarily prudent persons in like positions under similar circumstances. The behavioral standard was thus a moving target, and directors were informed by observing the conduct of their colleagues. Because this conduct covered a range from passive review to active management, the rule informed directors that a wide range of behavior was legally permissible. Presumably they were influenced primar-


\textsuperscript{128} SEC, Securities Exchange Act Release No. 15772 (April 30, 1979), [1979 Decisions] FED. SEC. L. REP. (CCH) para. 82,063 (proposing management disclosure of its opinion whether internal accounting controls provide reasonable assurance that specified objectives were met and describing any material weaknesses of such controls communicated by independent accountants to management).

\textsuperscript{129} SEC, Securities Exchange Act Release No. 16877 (June 6, 1980), 557 SEC. REG. & L. REP (BNA), H-1 (withdrawing rules proposed in Release No. 15772, supra note 128, and noting objections that rules were not designed to provide useful information to investors but to provide a basis for SEC enforcement actions under the Foreign Corrupt Practices Act).

\textsuperscript{130} SEC actions in cases cited supra note 119 add little to management's understanding of what are appropriate monitoring techniques, since they involve fairly egregious offenses where it was clear that some directors were active participants in major scandals.

\textsuperscript{131} Perkins, Genesis, supra note 16, at 674-75.
ily by the behavior of their peers on the board or boards on which they personally sat.

The outlines of the conduct rule were blurred by directors’ knowledge of the decision rule. Dicta (expressing the conduct rule) and holdings (reflecting the decision rule) diverged in the courts, and commentators disagreed about the rule of liability (the decision rule)—whether it was one of ordinary negligence or gross negligence. An examination of the holdings strongly suggests that the conduct rule has always been deliberately vague and open, but has been informed by a decision rule of gross negligence. In this respect a dissonance has always existed between conduct and decision rules, which may well be at the root of the current debate.  

This part argues that the ALI’s statement of the conduct rule has never born a meaningful relationship to the decision rule applied in the courts, except in a limited group of cases involving financial institutions. The principal purpose of this part is only to illustrate the tension between the rules, and the confusion caused by the inability of well-informed observers to keep them separate.

A. The ALI Formulation

Section 4.01 of the ALI project attempts first to restate the duty of care imposed on directors. Phillips characterized this as “black letter” law, drawn from treatises, indeed, one might say from hornbooks. In one sense there is nothing new in such a restatement—the law has always imposed some duty of care on directors, and it has always been necessary to provide a general formulation. The formulation of section 4.01(a) contains language reminiscent of many cases—that a director must perform

his functions: in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.  

132. Phillips, Principles of Corporate Governance: A Critique of Part IV, 52 GEO. WASH. L. REV. 653, 667 (1984), discusses the role of dissonance between conduct rules and decision rules, and argues that such dissonance is only appropriate when actors are largely unaware of the decision rule. Id. at 667, text accompanying n.65. Corporate directors, as he notes, are fully advised, and thus aware of the applicable decision rules.

133. Id. at 657-58. The characterization as “hornbook” law is mine.

134. T.D. No. 4, supra note 1, § 4.01(a).
This language is consistent with the modern trend to formulate the standard in statutes, as in the Model Business Corporation Act.\footnote{135} The standard is further developed with an obligation to make "such inquiry as the director or officer reasonably believes to be appropriate under the circumstances."\footnote{136} This expands the specification of the duties added by the ABA.\footnote{137} Nevertheless, the official comments claim that section 4.01(a) simply restates existing law.\footnote{138} The language of section 4.01(a) is indeed consistent with the formulation of the rule in many judicial decisions. Only the extension of the duty to make a reasonable inquiry represents a substantive addition to the general duty. The reporters consider the operative language of the conduct rule to be "care that an ordinarily prudent person would ... exercise." They further state that this formulation is supported by cases from eleven states, which the reporters claim have "unambiguously adopted a reasonable care standard."\footnote{139} Although these cases do state that the standard is one of reasonable care, and thus confirm in part the conduct rule, none address the particular elaboration of the conduct rule represented by the ALI's statement. Those cases all involve either banks and other financial institutions or the exoneration of defendant directors.\footnote{140} It is well settled that directors of financial institu-

\footnote{135} See, e.g., ABA REV. MODEL BUSINESS CORP. ACT § 8.30(b) (1984) ("A director shall discharge his duties ... (1) in good faith; (2) with the care an ordinarily prudent person in like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation." See also ABA MODEL BUS. CORP. ACT ANN., 35, 2 (1977 Supp.).\footnote{136} T.D. No. 4, supra note 1, § 4.01(a)(1).\footnote{137} See supra text accompanying notes 28-32.\footnote{138} T.D. No. 4, supra note 1, at 8-9.\footnote{139} Id. at 40.\footnote{140} T.D. No. 4, supra note 1, n.15 at 39-40 (citing Johnson v. Coleman, 179 Ark. 1087, 1094, 20 S.W.2d 186, 188 (1929) (suit against directors of mortgage company); Meyers v. Moody, 693 F.2d 1196 (5th Cir. 1982) (suit against insurance company director); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 246 (D. Neb. 1972), aff'd, 473 F.2d 537 (8th Cir. 1973) (defendants held not liable); Helt v. Bixby, 276 F. Supp. 217 (E.D. Mo. 1967) (suit against directors of insurance companies); Dykema v. Muskegon Piston Ring Co., 348 Mich. 129, 136, 82 N.W.2d 467, 471 (1957) (defendants not held liable); Boyd v. Applewhite, 121 Miss. 879, 897, 84 So. 16, 23 (1920) (suit against bank directors); Caldwell v. Eubanks, 326 Mo. 185, 30 S.W.2d 976 (1930) (suit against bank directors); Department of Banking v. Colburn, 188 Neb. 500, 198 N.W.2d 69 (1972) (suit against bank director); Charleston Boot & Shoe Co. v. Dunmore, 60 N.H. 85 (1880) (directors held not liable); Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (Sup. Ct. 1981) (suit against director of reinsurance brokerage firm); Jensen v. Republic Steel Corp., 32 Ohio L. Abs. 29, 36 (Comm. Pl. 1940) (judgment for defendants); Goff v. Emde, 32 Ohio App. 216, 221, 167 N.E. 699, 700 (Ct. App. 1928) (suit against directors of a discount company); Devlin v. Moore, 64 Ore. 433, 130 P. 35 (1913) (suit against bank directors); FMA Acceptance Co. v. Leatherby Ins. Co., 594 P.2d 1332, 1334 (Utah 1979) (suit against insurance company director).}
tions are special cases, and that the more intrusive reasonable care standard (as a decision rule) applies only in these special situations.\textsuperscript{141} Indeed, at one point the reporters' note (but not the official comments) concedes this, but rejects the distinction, on the specious basis that industrial corporations are often, at least in part, financial institutions.\textsuperscript{142} These comments ignore the rationale for the special treatment of banks and other financial institutions. These institutions are fiduciaries, holding funds of depositors and others in similar relationships.\textsuperscript{143} Thus, the reporters have generalized from a small set of cases in an inappropriate manner.

B. \textit{Historic Tensions Between Conduct and Decision Rules}

The Reporters are not alone in the error I attribute to them: Ballantine has preceded them, citing only bank cases in support of his statement of the duty of care.\textsuperscript{144} Indeed, the following discussion is designed to illustrate that confusion. Like the ALI Reporters, Ballantine discussed other standards of care for directors, such as gross negligence and the New York standard of an ordinarily prudent man in the management of his own affairs. But Ballantine came to the conclusion that "'[t]his conflict of standards, however, is more apparent than real because in practical applications such vague abstractions are meaningless, and the judge and the jury necessarily formulate their own measuring rods for themselves according to their own standards.'"\textsuperscript{145} In short, Ballantine conceded that aspirational statements of conduct rules have little to do with the decision rules applied by the courts.

Among other authorities, the ALI draft cites Fletcher's treatise in sup-

\begin{itemize}
\item \textsuperscript{141} See, e.g., W. CARY and M. EISENBERG, \textit{CASES AND MATERIALS ON CORPORATIONS} at 523 (5th unabr. ed. 1980); W. FLETCHER, 3A CYCLOPEDIA OF CORPORATIONS § 1035, at 28 (perm ed. 1975). Some believe that the characterization of banks and financial institutions as a special category for duty of care cases is unjustified. See H. BALLANTINE, \textit{supra} note 64, § 63a. \textit{But see} Francis v. United Jersey Bank, \textit{supra} note 140, justifying the higher standard of care on the basis that these corporations hold funds of others in a fiduciary capacity.
\item \textsuperscript{142} T.D. No. 4, \textit{supra} note 1, at 42-43 n.4.
\item \textsuperscript{143} See Francis v. United Jersey Bank, 432 A.2d at 824.
\item \textsuperscript{144} H. BALLANTINE, \textit{supra} note 64, at 159 n.11 (rev. ed. 1946), citing Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938) (receiver of bank sued administrator of estate of former bank director); Lippitt v. Ashley, 89 Conn. 451, 94 A. 995 (1915) (receivers of savings bank brought suit against directors); Medford Trust Co. v. McKnight, 292 Mass. 1, 197 N.E. 649, 655 (1935) (suit by bank against 25 past and present directors); Campbell v. Watson, 62 N.J.Eq. 396, 52 A. 120, 126, 134 (1901) (suit by bank receiver against directors) and Anderson v. Bundy, 161 Va. 1, 171 S.E. 501, 507 (1933) (suit against bank directors).
\item \textsuperscript{145} BALLANTINE, \textit{supra} note 64, at 159.
\end{itemize}
Fletcher, like Ballantine, recognizes the dissonance between the dicta (the conduct rule) and the holdings (the decision rule) and indicates that the articulated standard is not in fact the applied standard:

In determining whether directors are liable for negligent mismanagement, the courts have been prone to use fine sounding phrases in defining the duties of directors, and then proceed to decide the case without reference thereto—the rules laid down being such glittering generalities that the case could be decided either way without violating the rules. For this reason it is almost impossible to say that there is any considerable conflict of opinion. All that can be said is that (1) the rule is stated more explicitly and as imposing greater duties to some extent in some cases than in others, and that (2) in the final analysis each case is determined upon the particular facts appearing in the case at bar.\textsuperscript{147}

Fletcher, like Ballantine, does state that "[i]n most jurisdictions ordinary or reasonable care and diligence is the test . . ."\textsuperscript{148} But again, all of the cases cited involve the special cases of banks and financial institutions.\textsuperscript{149}

Lattin’s statement of the duty of care is also cited as consistent with the ALI’s formulation, but is subject to the same criticism, that all of the cases cited involve banks and financial institutions.\textsuperscript{150} Lattin does state that some courts have declared that directors are only liable for gross negligence, although he believes this standard is too low.\textsuperscript{151} More recently, an authoritative article comparing Delaware law with the Model Act waffled on the state of the law in Delaware.\textsuperscript{152}

In support of their ordinary negligence standard, the Reporters also

\textsuperscript{146} T.D. No. 4, supra note 1, at 30 n.2.
\textsuperscript{147} W. Fletcher, 3A Cyclopedia of Corporations 1029 at 14 (perm. ed. 1975).
\textsuperscript{148} Id. Id. 1035, at 33.
\textsuperscript{149} Id. 1035, at 34, n.1. (citing Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961) (action by corporation against officers and directors of an investment company); First National Bank of Lincolnwood v. Keller, 318 F. Supp. 339 (N.D. Ill. 1970) (action by bank against directors); HI-Pro Fish Products, Inc. v. McClure, 224 F. Supp. 485 (E.D. Ark, 1963) (action by creditors of bank against its directors for negligence and mismanagement); Mullins v. De Soto Securities Co., Inc, 56 F. Supp. 907 (W.D. La. 1944), (stockholder derivative action against dominant stockholders of a securities company) aff’d, 149 F.2d 864 (5th Cir. 1945).
\textsuperscript{150} T.D. No. 4, supra note 1, at 30 n.2, (citing N. Lattin, LATTIN ON CORPORATIONS § 78, 274 (2d ed. 1971)).
\textsuperscript{151} N. Lattin, supra note 106, at 274.
\textsuperscript{152} Veasey and Manning, supra note 99, at 926-29. The question was resolved in Aronson v. Lewis, 473 A.2d 805, 812 (Del. Super. Ct. 1984), in favor of a gross negligence standard.
cite an exhaustive study by the late Professor Joseph Bishop. Bishop concluded that directors were only held liable for gross negligence, and that the "ordinary care" standard was mere dicta. Despite the descriptions of the standard by the courts, Bishop concluded that "[t]he hard fact is that cases in which directors of business corporations are held liable, at the suit of stockholders, for mere negligence are few and far between." Aside from the special category of bank cases, Bishop found only four cases where directors of industrial corporations arguably have been held liable in derivative suits for ordinary negligence. Even in those cases he concluded that the ordinary care standard was mere dicta, and that the decision was based on other grounds. As Bishop put it, "none of these cases carries real conviction." A discussion of each will demonstrate how suspect they indeed are as support for a duty of ordinary care for directors.

Clayton v. Farish sustained a complaint charging negligence on the part of directors in their dealings with a cartel. The complaint alleged that in every instance the defendant directors acted in the best interests of one of the cartel members, and against the interests of their corporation, Standard Oil Co. of New Jersey. While the opinion articulates the ordinary care standard, it also articulates a gross negligence standard. More revealing, perhaps, are the conflict of interest charges, which demonstrate that the case really involved a breach of the duty of loyalty. The complaint alleged that the directors were in fact bribed by one of the cartel members, which delivered 500,000 shares of its stock to

153. T.D. No. 4, supra note 1, at 41-42 n.7, citing Bishop, supra note 80, at 1099-1100.
154. Bishop, supra note 80, at 1095.
155. Id. at 1095-99, text accompanying nn. 63-86.
156. Id. at 1099. See also Bishop, Type of Liability to Which Corporate Directors and Officers are Subject and Methods of Protection Against Such Liability, in PROTECTING THE CORPORATE OFFICERS AND DIRECTOR FROM LIABILITY, 327 (1970) ("[A] quite diligent research effort which I had a couple of students conduct a few years ago failed to turn up any case involving an industrial corporation in which it was possible to say that the director was held liable for ordinary negligence in managing the company's affairs.").
157. Bishop, supra note 80, at 1100.
158. 191 Misc. 136, 73 N.Y.S.2d 727 (Sup. 1947).
159. Id. at 740 ("The defendant, as a director of a corporation, should have taken the same care of its property that men of average prudence take of their own property.") (citing Cardozo J. in General Rubber Co. v. Benedict, 215 N.Y. 18, 23, 109 N.E. 96 (1915).
160. Id. at 740 ("Directors are liable 'if they suffer the corporate funds or property to be lost or wasted by gross negligence and inattention to the duties of their trust.'").
161. Id. at 740.
one defendant for a group of three dominant directors. The court stated that the negligence claim "also contains sufficient allegations to charge the defendant directors with fraud."

Bishop noted that there was a "cogent dissent" to New York Credit Men's Adjustment Bureau v. Weiss, and that the case has never been followed in New York. In Syracuse Television, Inc. v. Channel 9, Syracuse, a derivative action alleging excessive salary payments to employees survived a motion to dismiss. As Bishop points out, the court could hardly dismiss the complaint, since it was "cast in the terms of the statute." Neither the Weiss case nor the Channel 9 case involved affirmation of damage awards against the directors. In Weiss the case was remanded for a determination of whether the directors' actions damaged the company, while in Channel 9 the case merely went forward to trial.

The final case discussed by Bishop is Selheimer v. Manganese Corp. of America, a derivative action for waste and mismanagement. The corporation had raised funds to acquire and operate a plant in Pennsylvania through an intrastate offering exemption from securities registration. After acquiring the funds, and over the objections of counsel, they poured virtually all the funds into an inferior facility in another state. The Pennsylvania Supreme Court was faced with a statute that required directors to exercise such care as an ordinarily prudent man would exercise "in their own affairs", which the court recognized was not the majority view in the United States. The court held it would make no difference whether the usual standard applied or that of the new statute if the directors were guilty of "gross mismanagement." The court noted that "[i]t 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." Again, there were hints of conflicts of interest. The court noted that the trial court had found suspicious circumstances, including

162. Id. at 751.
163. Id. at 740.
164. Bishop, supra note 80, at 1100 n.95 (citing 305 N.Y. 1, 110 N.E.2d 397 (1953)).
165. 51 Misc.2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966).
166. Bishop, supra note 80, at 1100.
167. Selheimer v. Manganese Corp. of America, supra note 80, at 1100.
169. Id. at 582, 224 A.2d at 645.
170. Id. at 570, 224 A.2d at 639.
the use of an intermediary to purchase equipment that mysteriously disappeared. These circumstances created "a reasonable inference of willful misconduct and a pattern of self-enrichment by the managing defendants . . . and [this] militates against their good faith and fair dealing."171 Professor Bishop concluded that this case does not carry conviction on imposition of liability for ordinary negligence, because the directors actually appear to have been held liable for gross negligence, and because "the facts are heavy with the odor of self-dealing."172

IV. THE BUSINESS JUDGMENT RULE

Much of the furor concerning the ALI's proposals centers on the treatment of the business judgment rule.173 The ALI's formulation of the business judgment rule appears in section 4.01(c):

(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

1. he is not interested [1.15*] in the subject of his business judgment;

2. he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and

3. he rationally believes that his business judgment is in the best interests of the corporation.174

Subsection (c) does not contain the requirement that the director act with the care of an ordinarily prudent person in a like position. However, that requirement is in effect supplied by the repetition of a requirement that the director "reasonably" or "rationally" believe in the appropriateness of his actions—an objective standard, which can only be grounded in the behavior of a reasonably prudent person.175

The relationship between the conduct rule of section 4.01(a) and the

171. Id. at 572, 224 A.2d at 640.
172. Bishop, supra note 80, at 1100. See also Phillips, supra note 132, at 660, n.25.
173. See generally T.D. No. 1, supra note 1, § 4.01(d); T.D. No. 3, supra note 1, § 4.01(d) and T.D. No. 4, supra note 1, § 4.01(c). For a prominent and adverse reaction to these provisions see Business Roundtable Statement, supra note 65, at 46-51.
174. T.D. No. 4, supra note 1, § 4.01(c).
175. The Reporters concede that "reasonably believes" in the context of the inquiry requirement has both a subjective and an objective content, and that it is intended to have a meaning generally consistent with its use in analogous areas of the law, relying on RESTATEMENT (SECOND) OF TORTS § 11 (1965). T.D. No. 4, supra note 1, § 4.01(a)(1)-(a)(2), comment at 45. See also T.D. No. 4, supra note 1, § 4.01(c), comment at 67.
decision rule of section 4.01(c) illustrates that the two rules are extraordinarily difficult to separate. Section 4.01(a) sets out the duty of a director, requiring him to perform in good faith in a manner he reasonably believes to be in the best interests of the corporation, with ordinary care. The nature of the "reasonable belief" requirement is elaborated; it "includes the obligation to make . . . such inquiry as the director . . . reasonably believes to be appropriate under the circumstances." Section 4.01(c) sets out the business judgment rule principally as a series of qualifications to director immunity. If the director is not interested in the transaction, he does not violate his duty of care if he was informed with respect to the subject of the business judgment "to the extent he reasonably believes to be appropriate under the circumstances," and if he "rationally believes that his business judgment is in the best interests of the corporation." In either event, the statement of the business judgment rule closely parallels the statement of directors' duties. To that extent it merges conduct and decision rules by electing the prior conduct rule over the former decision rule.

This standard subjects a decision of the board to three discrete areas of judicial scrutiny. A director's interest in the transaction has been a traditional area of inquiry, and raises no new issues. But the ALI raises the issue of whether the director was "reasonably informed" to the extent he "reasonably believed necessary" at the time of the decision, which raises questions of the quantum of information possessed when a decision was made. This perverts the business judgment rule, which presumed an informed decision, and placed the burden of proof on the plaintiff. The ALI has converted a presumption into a prerequisite. The ALI project also introduces a new inquiry: whether the decision has a "rational basis," which raises questions about the thought processes of directors.

The following discussion examines the conditions imposed on the business judgment rule by the ALI, and all of the cases cited by the Reporters in support of their statements of law. The holdings of these cases simply do not support the claims made for them by the Reporters. If there is authority to support their position, they have totally failed to marshal it.

176. T.D. No. 4, supra note 1, § 4.01(a).
177. T.D. No. 4, supra note 1, § 4.01(a)(1).
A. The Reasonable Inquiry Requirement

1. The ALI Formulation

The condition that the director must be informed to the extent he reasonably believed appropriate under the circumstances is tied by the official commentary to the requirement of section 4.01(a)(1). Section 4.01(a)(1) states that the director's duty of care "includes the obligation . . . to make such inquiry as the director or officer reasonably believes to be appropriate under the circumstances."178

The support for this requirement is commentary or dicta to the effect that in applying the business judgment rule, "it is presupposed that judgment—reasonable diligence—has in fact been exercised."179 Here the move from presumption to prerequisite is made explicit. The justification, as the Reporters point out, "is to encourage directors and officers to put themselves in a position to make as informed and careful a decision as circumstances permit."180 This is an explicit merger of conduct and decision rules, with the emphasis on the conduct rule.

The official comments state that various preparatory decisions to the making of a business decision, such as how much information or advice to acquire in evaluating a new product or project, are protected by the business judgment rule.181 This commentary concedes that directors may be under severe time pressure under certain circumstances, which may compel "risk taking, which includes the risk of not having all relevant facts concerning a proposed transaction . . ."182 The commentary further states that "[a] decision to accept the risk of incomplete informa-

178. See T.D. No. 3, supra note 1, § 4.01(d)(3) ("had a rational basis for believing. . ..") and T.D. No. 4, supra note 1, § 4.01(c) comment at 64 ("The great weight of case law and commentator authority supports the proposition that an informed decision, [made after reasonable inquiry], is a prerequisite to the legal insulation afforded by the business judgment rule."). Commentary in T.D. No. 1 disclaims an intent to impose all of the duty of care requirements on directors as a prerequisite to the availability of the business judgment rule, conceding that the rule would then be superfluous. T.D. No. 1, supra note 1, § 4.01(d) comment b, at 206. This disclaimer has been dropped from T.D. No. 4, suggesting even closer judicial scrutiny than the earlier drafts.

179. T.D. No. 4, supra note 1, § 4.01(c) at 64, (citing Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944)); Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 394 (2d Cir. 1980); H. BALLANTINE, LAW OF CORPORATIONS 638 at 161 (rev. ed. 1946).

180. T.D. No. 1, supra note 1, § 4.01(d) comment b at 206-07 (citing Arshft, The Business Judgment Rule Revisited, 8 HOFSTRA L. REV. 93, 111 (1979) and an unpublished manuscript of one of the reporters, Small, The Rights and Duties of Directors Under the Business Judgment Rule 12 (unpublished manuscript 1981)).

181. T.D. No. 4, supra note 1 § 4.01(b) comment at 56.

182. T.D. No. 4, supra note 1 § 4.01(c) comment e, at 65.
tion, so long as the director reasonably believes such informational risk taking to be appropriate under the circumstances, will be fully consistent with the application of the business judgment rule . . . .”¹⁸³

But what one comment gives, another takes away, by limiting the circumstances under which decisions made on less than perfect information may be defended. The illustrative circumstances given by the commentary that justify acting on less than complete information involve a prospective white knight, facing a decision to bid for a target where target shareholders must make a decision on a pending bid within two days, so that the opportunity will be lost forever if no decision is reached immediately. Further, the illustration points out that most of the target’s activities and assets have been carefully evaluated, so the areas of incomplete information are confined to a small but significant aspect of the target’s business.¹⁸⁴ The implication is that only the most urgent of circumstances will justify operating on less than perfect information in making a business decision. This example ignores the real world, in which many hostile tender offers are made solely on the basis of publicly available information, without benefit of “due diligence.”

2. The Real Law of Inquiry

The ALI’s verbal formulation finds support in the standard treatises and in dicta in judicial opinions. However, it fails to capture the extent of judicial deference to directors’ decisions about how much information was required to reach an informed judgment. It does not appear to be an extraordinary statement for the reporters to say not that directors are presumed to have acted in an informed manner, but that the safe harbor of the business judgment rule “presupposes a deliberative process and an informed decision.”¹⁸⁵ In the context of the ALI project this must be read to mean not that these elements are presumed, but rather that directors must prove them before becoming entitled to the protection of the business judgment rule. Unfortunately, the cases cited in the reporter’s note to the introductory comments do not entirely support this claim.¹⁸⁶

¹⁸³ Id. at 65.
¹⁸⁴ Id. § 4.01(c) comment f, at 67-70. The tenor of illustration 2, id, at 71-72, is similar.
¹⁸⁵ T.D. No. 1, supra note 1, Part IV, introductory comment c, at 133.
¹⁸⁶ T.D. No. 1, supra note 1, Part IV, introductory comment e, at 137, 139-40.
decision not be tainted by the interest of a single director who had determined to oppose a takeover "at all costs."187 While the deliberative procedures used by the board have subsequently been cited as models, that discussion was not necessary to the holding of the case.188 Schein v. Caesar's World, Inc., cited by the Reporter to support a requirement of reasonable care, can only be described as a "phantom footnote" that lends no support whatever to the statement.189 The court of appeals affirmed per curiam the trial court's grant of summary judgment for the defendant directors, attaching the unpublished opinion of the district court as an appendix.

Evans v. Armour & Co. is consistent with the claim that the business judgment rule presupposes a decision that "has been exercised reasonably and with due care."190 But the cases cited by the Evans opinion stand only for the proposition that directors "are liable only where they are grossly negligent or fraudulent."191 Thus Evans represents a questionable application of controlling precedent.

Gimbel v. Signal Companies, Inc., another case challenging the validity of a business decision, contains dicta to the effect that the business judgment rule "requires the Court to start from the normal presumption that Signal's Board of Directors acted in good faith in approving the sale . . . ."192 The court held that the rule weighs in favor of the directors' decision "unless the complaining shareholders can prove fraud or a clearly inadequate sale price," which must be "so clearly inadequate as constructively to carry the badge of fraud."193 Thus, the case would more appropriately support a statement about the nature of the presumptions and deference to be given a decision once reached. It is unfortunate that the Reporters have chosen to rely on a particularly naive Delaware

187. 638 F.2d 357, 383-84 (2d Cir. 1980). Indeed, citing a takeover case is particularly inappropriate in a general statement of the business judgment rule, since these cases present special circumstances, which the ALI has generally reserved for Part VI of the project.

188. See infra text at notes 250-63 for a discussion of the use of Treadway in the Hanson Trust decision.

189. 491 F.2d 17 (5th Cir. 1974). "Phantom footnotes" have previously been observed in the work of Nader, Green & Seligman, CONSTITUTIONALIZING THE GIANT CORPORATION, supra note 10, by R. Hessen, Creatures of the State? The Case Against Federal Chartering of Corporations, BARRON'S, May 24, 1976, reprinted in 1976 Senate Hearings, supra note 33, at 21, 24.


192. 316 A.2d 599, 608 (Del. Ch. 1974).

Supreme Court decision on valuation issues.\textsuperscript{194} If anything, the case illustrates that those dealing with corporations in times of price fluctuations may find their agreements renegotiated by the courts, if hindsight and price fluctuations subsequently suggest the directors made a wrong (but not uninformed) guess about future prices.\textsuperscript{195}

Cases cited in the Third Tentative Draft provide no more support for the reasonable inquiry requirement. Indeed, \textit{Joy v. North} provides support for greater judicial deference. The opinion holds only that directors may not completely abdicate their authority to others, that "[d]irectors who willingly allow others to make major decisions affecting the future of the corporation wholly without supervision or oversight may not defend on their lack of knowledge, for that ignorance is a breach of fiduciary duty."\textsuperscript{196} The opinion describes certain directors as having been "left in the dark," which suggests they had no information whatever, and raises questions of active concealment of conflicts of interest by some inside directors.\textsuperscript{197} The case stands only for the proposition that directors who delegate decisions to others and choose to remain in total ignorance may be liable, unless they can show an excuse for their failure to stay abreast of the consequences of their delegation.

\textbf{B. The Rational Basis Requirement}

\textit{1. The ALI Formulation}

The "rational basis" prerequisite for protection of the business judgment rule is closely related to the informational requirement.\textsuperscript{198} In Ten-

\textsuperscript{194} In \textit{Gimbel} the court was persuaded of the prima facie inadequacy of the sale price by the wide disparity in the appraisals of experts for each side, thus in effect choosing to believe (or give weight to) the opinions of one side, when no evidence or reasons were cited for this preference. The court, in effect, exercised its own business judgment about value. For a discussion of the case with which experts can create wide differences in valuations by varying assumptions about appropriate discount rates see Fischel, \textit{The Appraisal Remedy in Corporate Law}, 1983 AM. BAR FOUN. RES. J. 875, 891. There is dicta in \textit{Gimbel} indicating that the board should have obtained more current information about value before approving the sale, which is consistent with the ALI's position.

\textsuperscript{195} All contracts are bets about future prices, and assignments of the risk of price fluctuations, with the buyer bearing the risk of a decline in value, and the seller bearing the risk of an increase in value.


\textsuperscript{197} 692 F.2d at 896.

\textsuperscript{198} In T.D. No. 1, \textit{supra} note 1, and T.D. No. 3, \textit{supra} note 1, § 4.01(d)(3) the requirement was that a director must have "had a rational basis" for the business judgment. In T.D. No. 4, \textit{supra} note 1, § 4.01(c) requires that "he rationally believes that his business judgment is in the best interests of the corporation."
tative Draft No. 1 the Reporters introduced this concept with the claim that while “[t]he black letter formulation of the business judgment rule . . . is new, . . . each of its basic elements is supported by substantial precedential authority.”199 The commentary further states that this is a more liberal standard than the formulation in some cases that the business judgment must be “reasonable” to be upheld.200 The commentary rejects a simple “good faith” test as providing “too much legal insulation for directors and officers.”201 This apparently rejects a presumption of reasonable decision-making where good faith and a lack of conflicts of interest are shown.

Once again, the formulation is inconsistent even with the formulation of the rule in the cases cited by the Reporters. Prominent among them are cases that refer to the test as one of whether “any rational business purpose can be attributed” to the decision.202 The cases cited in the reporter’s note to section 4.01(c) of Tentative Draft No. 4 contain much stronger language: “so unwise or unreasonable as to fall outside the permissible bounds of the directors’ sound discretion . . . “,203 “business judgment rule director liability is predicated upon concepts of gross negligence”,204 and unless “so gross as to appear absurd.”205 The difference between the obvious liberality of the judicial formulations of the rule and the ALI’s formulation has already led to a judicial weighing of evidence and reasons for decisions that would intrude well into the management process.206

The cases cited by the ALI Reporters include a case involving challenges to the decisions themselves—whether the directors’ actions should be set aside for lack of such a rational basis and purpose, rather than

199. T.D. No. 1, supra note 1, § 4.01(d) comment, at 192; see also T.D. No.3, supra note 1, § 4.01(c), comment a, at 58 (“The formulation of the business judgment rule set forth in § 4.01(d) is believed to be consistent with present law as it would be interpreted in most jurisdictions today . . . “).

200. T.D. No. 4, supra note 1, § 4.01(c) comment f, at 68.

201. Id. at 69.


204. Aronson v. Lewis, supra note 152 at 145, cited in T.D. No. 4, supra note 1, at 75.

205. Spering’s Appeal, 71 Pa. 11 (1872), cited in T.D. No. 4, supra note 1, at 76.

206. See infra, cases cited at subpart D of this Part.
claims of director liability.\textsuperscript{207} Hinsey has characterized the business judgment doctrine as protecting directors, decisions, and the business judgment rule as protecting directors themselves from liability.\textsuperscript{208} This blurring of the rule and the doctrine obscures the cost to corporations of rendering all corporate decisions subject to renegotiation in the courts at the instance of an unhappy shareholder.

2. The Real Law

A close inspection of the few cases cited in support of the rational basis test demonstrates that the reporters have created a straw man, in the form of a "reasonableness" test, which they reject in favor of protecting only decisions with "a rational basis."\textsuperscript{209} Instead, the real choices should have been between a gross negligence test and a good faith test, both of which find more support in the case law, even in those cases cited by the Reporters. The move to a rational basis test seems innocuous enough at first blush, especially in view of the distraction of an alternative of "reasonableness", which involves fuller judicial review. Yet application of the rational basis test in recent decisions demonstrates the dramatic impact such a shift in language can make. The notion of a "rationally based" decision seems to have been transformed by some courts into a balancing of the possible costs and benefits of a decision. This is a dramatic and inappropriate intrusion into the boardroom. Indeed, the verbal formulation of the test in \textit{Gimbel v. Signal Companies, Inc.}, cited by the Reporters for the duty of inquiry, draws on an earlier opinion that defers to directors' decisions on price "unless the inadequacy is so gross as to display itself as a badge of fraud" and "can be explained only on the theory of fraud, or a reckless indifference to the rights of others interested."\textsuperscript{210}

A reading of the cases cited by the reporters makes two propositions clear. First, courts support directors' decisions for which, in hindsight, there is \textit{any} rational basis, or \textit{any} business purpose. Second, in doing so, there is much support for a standard phrased in terms of more traditional

\textsuperscript{207} Panter v. Marshall Field & Co., supra note 202, involved a suit for injunctive relief as well as for damages in connection with defensive responses to a hostile takeover bid.


\textsuperscript{209} See T.D. No. 1, \textit{supra} note 1, at 209 and § 4.01(d), Reporter's Note, at 213; T.D. no. 4, \textit{supra} note 1, at 67-68 and § 4.01(c), reporter's note, at 75-76 for rejection of the reasonableness test.

\textsuperscript{210} \textit{Gimbel v. Signal Co., Inc.}, \textit{supra} note 192, at 152, 316 A.2d at 610, (citing Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1, 19, 120 A. 486, 494 (Del. Ch. 1923)).
language of standards of care—that directors' decisions will be upset, and
directors held liable, only for gross negligence. Some of these cases pro-
vide support for a standard rejected by the ALI—that decisions will not
be upset in the absence of fraud, illegality or bad faith.²¹¹ Couching
the business judgment rule in these terms would have done much to clarify
the traditional judicial deference to business decisions. An examination
of the decisions cited by the reporters in three drafts of the ALI project
demonstrates that the overwhelming weight of authority supports either
a good faith or a gross negligence version of the rule.

Cases cited that support decisions made with "any rational business
purpose" include Panter v. Marshall Field & Co. (a takeover defense case,
validating the decision);²¹² Sinclair Oil Corp. v. Levien;²¹³ and Whittaker
Corp. v. Edgar, (a takeover defense case, validating the decision).²¹⁴

The alleged support for a "reasonableness" requirement demonstrates
that the Reporters were only searching for a straw man to demonstrate
that their proposed shift in the business judgment rule was a modest one.
Cases cited for the "reasonableness" requirement include only Cramer v.
General Tel. & Electronics Corp., a derivative action "demand excused"
case. The Cramer opinion states no more than the proposition that
courts retain some power to review the reasonableness of decisions of
special litigation committees—a matter of considerable controversy, but
not dispositive of the rule in business decisions, since decisions to dismiss
are mixed questions of legal and business judgment.²¹⁵ McDonnell v.
American Leduc Petroleums, Ltd. contains dicta about the business judg-
ment rule, in the face of total abdication of responsibility by a director.
The director interpreted a promise she made to state regulators to allow
honest and independent managers to remain in office as a promise of total
passivity as a director, which the court held was not a "reasonable" inter-
pretation.²¹⁶ Abbey v. Control Data Corp., cited for the proposition that
the business judgment cases provide broader protection to directors than

²¹¹ The cases cited are found in T.D. No. 1, supra note 1, at 139-40 and T.D. No. 4, supra note
1, at 64-68 and 74-76.
²¹³ 280 A.2d 717, 720 (Del. 1971).
²¹⁵ 582 F.2d 259, 275 (3d Cir. 1978), (dismissing derivative suit for failing to make a demand
on the board), cert. denied, 439 U.S. 1129 (1979). The court did not determine whether state or
federal law governed. It is clear that the discussion of the extent of judicial review was merely dicta
because it was not necessary to the decision.
²¹⁶ 491 F.2d 380, 384 (2d Cir. 1974).
a reasonableness test, is no longer good law. That opinion applied the business judgment doctrine to a board decision to terminate a derivative action, while later Delaware decisions have declined to do so, in view of the potential "structural bias" of special litigation committees.

Some cases cited simply have no bearing on the business judgment rule. Myers v. Moody, for example, was a fraud case, where the jury found gross negligence on the part of the defendant.

Other cases support a rule rejected by the ALI—that directors' decisions can be challenged only for fraud or bad faith. Indeed, one such case, Kamin v. American Express Co., is cited not for that proposition, but as a case that omitted reference to both "reasonableness" and "rational basis" in setting forth business judgment criteria. While, that characterization is literally true, it is disingenuous, since the comments fail to explain that these phrases were omitted because the court adopted an even more deferential standard.

At the same time, the reporters provide much support for a rule of either gross negligence or fraud or bad faith as the standards of the business judgment rule. Among the cases cited are Spering's Appeal, ("unless so gross as to appear absurd"), Warshaw v. Calhoun, ("bad faith . . . or a gross abuse of discretion . . . .") and Gimbel v. Signal Companies, Inc., ("unless the inadequacy [of price] is so gross as to display itself as a badge of fraud" and "can be explained only on the theory of fraud, or a reckless indifference to the rights of others interested"). Most importantly, they cite the opinion of the leading court for corporate law, in its landmark decision in Aronson v. Lewis. There the Delaware Supreme Court stated that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on a informed basis, in good faith and in the honest belief that the action taken

218. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), holding that the court should apply its own business judgment to review a decision of a special litigation committee to terminate a derivative action, where doubts remain about the independence of the committee.
219. 693 F.2d 1196, 1210 (5th Cir. 1982).
221. T.D. No. 3, supra note 1, at 71.
222. 71 Pa. 11 (1872).
224. Supra note 192, at 152.
was in the best interests of the company."226 The court then reviewed all of its prior holdings in the area, and concluded that "under the business judgment rule director liability is predicated upon concepts of gross negligence."227 To state the rule while ignoring this statement, which is the law applicable to an enormous percentage of all large American business corporations, can hardly be regarded as an accurate statement of existing law.228 Addressing the requirement of a rational basis, the court stated that the rule "has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."229 As the court pointed out, "[t]he burden is on the party challenging the decision to establish facts rebutting the presumption."230

Thus the case law supports a much stronger statement of the business judgment rule which would clarify that directors, absent conflicts of interest, are entitled to a presumption of adequate investigation and good faith in their decisions. That presumption places a burden on those complaining of director action to demonstrate the total lack of facts, or of investigation, or of possible reasons, to support a decision.

C. The Real World—Investigation Is a Matter of Business Judgment

Information, like any other good, is costly to produce, and rational decision-makers will only produce it up to the point where the expected benefits from more information are equal to the marginal costs of pro-

226. Id. at 812.
227. Id. (citing Veasey & Manning, Codified Standard - Safe Harbor or Uncharted Reef?, supra note 99, at 928). Note 6 of Aronson, supporting the conclusion, stated:

While the Delaware cases have not been precise in articulating the standard by which the exercise of business judgment is governed, a long line of Delaware cases holds that director liability is predicated on a standard which is less exacting than simple negligence. Sinclair Oil Corp. v. Leven, 280 A.2d 717, 722 (Del. 1971), rev'd, 261 A.2d 911 (Del. Ch. 1969) ('fraud or gross overreaching'); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970), rev'd, 255 A.2d 717 (Del. Ch. 1969) ('gross and palpable overreaching'); Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966) ('bad faith . . . or a gross abuse of discretion') Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963) ('fraud or gross abuse of discretion'); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972) ('directors may breach their fiduciary duty . . . by being grossly negligent'); Kors v. Carey, 158 A.2d 136, 140 (Del. Ch. 1960) ('fraud, misconduct or abuse of discretion'); Allauin v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) ('reckless indifference to or a deliberate disregard of the stockholders').

228. Jonathan Macey of Cornell Law School has calculated that as of January 1, 1986 43.3% of all companies listing equity securities on the New York Stock Exchange were incorporated in Delaware. 1 NYSE GUIDE (CCH), 70-107, 725-99.
229. 473 A.2d at 813.
230. Id. at 812, (citing Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971)).
duction. The difficulty is that the benefits from more information generally cannot be known until the information is actually acquired. It may be that the first bit of information acquired by a board about an upcoming decision correctly points the direction, but one remains uncertain about it until all information has been acquired. That may be an impossibly costly task, both in time and resources, and business executives, like others, are faced with the choice of how far to go in pursuit of information before deciding. Where the range of choices or possible outcomes is small the expected benefits from additional information will also be small. On the other hand, where the range of possible outcomes is large the expected payoffs from obtaining further information are likely to be larger, holding the costs of search constant.\textsuperscript{231} But at the beginning of a search, the decision-makers may not be fully aware of the range of expected outcomes, and thus may be uncertain about the payoffs from more information. Experienced directors and business executives will have better means for estimating the range than those lacking such experience, such as judges and attorneys.\textsuperscript{232}

Thus experienced business executives presenting a decision to a board, or those sitting the board, will know from experience the likelihood that further investments in information acquisition will produce important new facts that may alter the decision. They will, of course, be mistaken from time to time; it may be that the very next piece of information could have protected the corporation from a loss. But that is the nature of the predictive process: decisions are made under conditions of uncertainty.

This rather formal description of the decision-making process is supported by observers of board practices. The board typically is presented with a flow of information in connection with a wide variety of decisions over time, all of which adds to the background against which each successive decision is made.\textsuperscript{233} Decisions are not made as before courts or administrative agencies; common background information will be assumed, not presented for the record. Decisions about how many questions to ask or whether to request reports from outside experts, or further exploration by management, are informed by the past experience of di-

\textsuperscript{231} The basis for this description is drawn from Stigler, \textit{The Economics of Information}, 69 J. Pol. Econ. 213 (1961).
\textsuperscript{232} \textit{Id.} at 218-19.
\textsuperscript{233} Manning, \textit{The Business Judgment Rule and the Director's Duty of Attention: Time for Reality}, 39 Bus. Law. 1477, 1494 (1984) ("the heart of the director's true responsibility is attention to his ongoing multiple functions: a process, a flow of events, a continuum of the company's current history.").
rectors with the value of such additional searches. In most cases, unless a lawyer is present orchestrating events, decisions about whether to search for more information will not be made explicit. Practical business executives will act without what they regard as superfluous discussions of what they might know under ideal and hypothetical conditions.

D. The Consequences of Judicial Review of the Quantum of Information

Several decisions announced since the appearance of Tentative Draft No. 1 provide the only support for the ALI’s statements of the business judgment rule. Those decisions also illustrate the perils of following such a rule. They threaten the quality of corporate decisions and the risks directors will be willing to undertake.

1. Ex Post Determinations of the Adequacy of Information

Smith v. Van Gorkom represents a landmark in the decisions of the Delaware Supreme Court.234 The court held that in the sale of the business of Trans Union Corporation the directors failed to reach an informed decision where the CEO of the company played an active role in initiating the sale and in setting the price, but neglected to describe all of the details of the negotiations to the board, and where the board was “uninformed as to the intrinsic value of the Company.”235 Finally, the court held, disagreeing with the board’s construction of a contract not in the record, that the directors “had no rational basis for expecting that a market test was attainable.”236

The court’s treatment of intrinsic value is illustrative of the difficulties to be encountered when courts inquire on their own whether a decision is an “informed” one. The proposed contract presented to the board called for the sale of the business for $55 per share when its stock had previously been trading at $38.237 The company had been frustrated by its inability to utilize its investment tax credits, and the board was aware that a business combination, whether by acquisition or sale, presented a reasonable means for obtaining full benefit from its tax situation.238 Because no investment banker rendered an opinion on the “intrinsic value”

235. Id. at 874.
236. Id. at 878.
237. Id. at 867.
238. Id. at 864-65.

Washington University Open Scholarship
of the company or the fairness of the price, and because no such opinion was provided by anyone on the corporate staff, the court held that the board was not fully informed when it agreed to sell the company for nearly a 40% premium over its then market value.239 The tragedy is the court's naive assumption that such a thing as "intrinsic" value exists for a firm. No respectable financial economist or investment banker would attempt to assign an "intrinsic value" to a financial asset.240 Its only value is its ability to produce a stream of future benefits for its owners, in dividends or appreciation, capitalized at the appropriate discount rate.241 In this case, the assets, viewed as a tax shelter, had a determinable value in the hands of those able to utilize the shelter, as Trans Union was not. Internal calculations could be made by Trans Union officials of the tax savings, and hence cash flow increases, available to any buyer, and further calculations could also be made on how much debt this cash flow would support. The premium over the market was a substantial one, lending further credence to a conclusion that the decision was a reasonable one.

In efficient capital markets prices provide that information with a high degree of accuracy, and investors as well as directors can rely on market prices as the consensus of intelligent traders and investors about value.242 It is the market, not expert witnesses, that selects the appropriate capitalization rate.243 Only where material non-public information exists is it likely that market prices may not fully reflect the best possible judgment

239. Id. at 878.


241. For a general description of valuation, see BREALEY & MYERS, supra note 240 at 61-83. See also FISCHER, supra note 194.


243. FISCHER, supra note 194, at 891, suggests how readily experts can manipulate valuation formulae to achieve desired (and radically disparate) appraisals of firms.
about value. There was no mention of the presence of such information in the Trans Union opinion. Indeed, where, as here, the business involves passive ownership of fungible investment assets, the presence of such information is highly unlikely. In its attempt to prove that intrinsic value was different from market value, the court cited only the testimony of several directors to the effect that most chief executives think the market undervalues their companies' stock. It is hardly surprising that most CEOs believe their efforts are not fully appreciated, but it is not evidence of undervaluation, either systematic or sporadic. The evidence is all to the contrary.

The result was that the court upset a decision made by a disinterested board, charged with no fraud or illegality, on the recommendation of a CEO with a substantial ownership interest, because the court did not believe these directors had sufficient information to protect their decision under the business judgment rule. As one dissenting justice pointed out, the five inside directors had 68 years of combined experience, while the five outside directors had 53 years cumulative experience as directors of this company. One outside director was an economist, formerly a professor of economics at Yale, dean of the Graduate School of Business at the University of Chicago, and presently Chancellor of the University of Rochester. The other four were Chief Executives of major business corporations. As the dissenting justice observed, "[d]irectors of this caliber are not ordinarily taken in by a 'fast shuffle.'" The dissent describes the opinion as a "comedy of errors." That description has been echoed by later commentators.

Hanson Trust PLC v. ML SCM Acquisition, Inc. represents the first explicit application of the ALI's approach to a business judgment. SCM Corporation was the subject of a hostile tender offer by Hanson, and sought, through its investment bankers, to locate a white knight for a competing bid. Out of 40 companies contacted, only one, Merrill Lynch, Pierce, Fenner & Smith, Inc ("Merrill") was seriously interested.

244. 488 A.2d at 876.
245. See authorities cited supra note 242-43.
246. 488 A.2d at 894.
247. Id. at 894.
248. Id. at 894.
250. 781 F.2d 264 (2d Cir. 1986).
251. Id. at 268.
In return for its commitment to make a bid for the entire company, Merrill obtained an engagement fee and a "breakup fee" if another bidder succeeded, thus assuring some compensation for the expenses the bidder was about to undertake.\textsuperscript{252}

When Hanson increased its hostile bid in response to Merrill's offer, Merrill declined to proceed with a new and higher bid without further compensation. In order to induce the white knight to make an even higher bid, SCM offered lock-up options on its "crown jewels"—its most attractive divisions—if Hanson should succeed.\textsuperscript{253} The option prices were approved by a disinterested board after receiving an investment banker's opinion that the option prices were "within the range of fair value."\textsuperscript{254} The result of the lock-up was, as expected, termination of Hanson's bid, because Merrill could have purchased major assets at prices representing less than full value if Hanson's bid had succeeded.\textsuperscript{255} In essence, when the bidding had stopped, in order to induce a higher bid from Merrill, SCM's board gave an option that would induce one more (higher) bid.

Applying New York law, the court held that the board's duty of care requires "reasonable diligence" in gathering and considering material information—citing the ALI's formulation in T.D. No. 4.\textsuperscript{256} But the court declined to presume that the judgment was made on adequate information. Instead, the court proceeded with its own examination of the adequacy of the valuation information the board possessed at the time it approved the lock-up.\textsuperscript{257} As Judge Kearse's dissent put it, "while purporting to apply the business judgment rule, the majority proceed[ed] to engage in extensive exploration of asset valuation of the sort normally reserved to corporate directors."\textsuperscript{258} Aside from reliance on the opinions of respected investment bankers and outside corporate counsel, the board asked questions on virtually all aspects of the options open to them.\textsuperscript{259}

\textsuperscript{252} Id. at 269.
\textsuperscript{253} Id. at 270-71.
\textsuperscript{254} Id. at 271.
\textsuperscript{255} Id.
\textsuperscript{256} Id. at 274 (citing T.D. No. 4, supra note 1, § 4.01(e)(2)).
\textsuperscript{257} "Thus, while directors are protected to the extent that their actions evidence their business judgment, such protection assumes that courts must not reflexively decline to consider the content of their 'judgment' and the extent of the information on which it is based." 781 F.2d at 275.
\textsuperscript{258} Id. at 286.
\textsuperscript{259} [T]he directors asked questions as to, inter alia,
- the valuation of the Merrill Lynch deal,
- the possibility that Hanson would raise its bid,
The majority focused rather on questions the board did not ask, and information the investment bankers did not supply. Indeed, the majority seemed to turn the question of what constitutes the proper amount of information into a question of law, by citing the steps taken in *Treadway Companies, Inc. v. Care Corp.* as evidence of what this board should have done. Thus, the court believed that SCM’s directors should have “‘armed’ their bankers with financial questions to evaluate; . . . requested balance sheets; . . . adjourned deliberations for one week to consider the requisitioned advice; and . . . conditioned approval of the deal on securing a fairness opinion from their bankers.” Accordingly, the majority held that the directors failed to exercise due care in informing themselves of material information, and set aside the lock-up options as unfair. The court rejected the trial court’s holding that valuation involves a business judgment, and rejected the justification that some kind of an option was required to obtain a better bid from the white knight. The court pointed to the fact that the lock-up ended the bidding as evidence that no benefit redounded to SCM and its shareholders from the lock-up.

In so holding the court had to ignore the fact that the lock-up induced a $74 bid when the hostile bid was at $72. The court failed to understand the bidding contest. The contest was over when Merrill announced its withdrawal. At that point, Hanson had no incentive to increase its $72 bid. While the lock-up may have ended the bidding, it did so at a higher price than Hanson was then willing to pay. Thus, in determining the adequacy of information about value, the court became enmeshed in a debate about whether the lock-up was necessary to secure a higher bid.

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- whether asset options such as that proposed had been legally upheld,
- the Goldman Sachs evaluation of the Merrill Lynch deal and the evaluation of the debentures,
- the possibility of a shareholder suit,
- the trigger of the asset option,
- what parts of the SCM business Hanson was interested in,
- the impact of the proposed deal on the employees of the company,
- the continuing viability of the company,
- whether a higher price might be obtained for these assets,
- what the equity ownership of the new company would be under the new deal, and
- whether Merrill Lynch would do the deal without the asset option.

*Id.* at 290 (dissenting opinion of Judge Kearse).

260. *Id.* at 275 (citing *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980)).
261. 781 F.2d at 275.
262. *Id.* at 282-83.
263. *Id.* at 271, 281.
This question is necessarily a business judgment. The majority did not even understand the nature of the bidding game.

Not all courts have read section 4.01 as suggesting such an intrusive role for the judiciary. In the context of board approval of a white knight's bid, the Sixth Circuit has read Ohio law, as informed by the ALI's project, as requiring the plaintiff to show that directors acted in bad faith "or without requisite objectivity" before directors must defend their actions.264

2. Bureaucratization of Corporate Decision-Making

Two lessons become clear for corporate counsel advising boards during decisions about selling the corporation. First, the paper record must be replete with information normally part of the background knowledge of directors, and with explicit information from experts designed to persuade courts that sufficient information was presented. Second, to the extent that less than one hundred percent of the possible information is presented to the board, explicit discussions should take place, for the record, of the cost considerations and time constraints that justify proceeding on less than a one hundred percent record. No matter how complete the presentations of management and outside experts, care should be taken to demonstrate that the board engaged in an independent inquiry, and indeed, made its own determination of whether there is a sound basis for any expert opinions.265 Directors must now inquire about the nature of the facts investigated by investment bankers, according to the Hanson majority.266 Indeed, both opinions suggest that it is not enough that opinions are given about the range of fair values, or that the price offered is not unfair; experts should give a precise valuation opinion, as if there were a single determinable "intrinsic" value.267 In short, directors should be aided by their attorneys and investment bankers in papering the record.

264. Radol v. Thomas, 772 F.2d 244, 257 (6th Cir. 1985). The court stated that "Ohio courts adhere to the 'business judgment rule,' and will not inquire into the wisdom of actions taken by the directors in the absence of fraud, bad faith or abuse of discretion." Id. at 256.

265. See 488 A.2d at 877.

266. 781 F.2d at 276 ("The directors did not seek any documents in support of Goldman Sachs' conclusory opinion", and that other facts "should have led the directors to investigate, rather then rely baldly upon, the oral opinion as to fairness.").

267. 781 F.2d at 276; 488 A.2d at 891.
V. The Response to Law Reform

Dean Richard West, now of the New York University Business School, predicted the results of the ALI’s characterization of the duties and liabilities of directors. He argued that it would deter qualified candidates from serving on corporate boards, and would lead those remaining to be more cautious, “to take less risk, and be less innovative.”\(^{268}\) He also noted the “prospect of more derivative suits, with all of the various costs attendant thereto.”\(^{269}\) While no comprehensive empirical studies have been performed, the evidence, to a casual empiricist, is overwhelmingly in support of West’s prediction. Even the first hints of judicial acceptance of the changes suggested by the ALI, coupled with other forces, have caused a disruption of corporate practices. If increases in liability insurance premiums for officers and directors are a proxy for increased derivative suits, the evidence clearly supports West’s last prediction. In the face of the unavailability of liability insurance, or drastic changes in exclusions and deductibles, outside directors have resigned in large numbers. Increased caution and reduced risk-taking and innovation are more difficult to observe, because they involve opportunities not seized. But there was one thing Dean West did not predict: beginning with Delaware, in response to *Trans Union*, there has been remarkably rapid and widespread legislative response, generally in the form of permission for corporations, through charter amendments, to contract out of director liability for violations of the duty of care.

A. The Liability Crisis

It is not the purpose of this article to provide a comprehensive survey of the “liability crisis” that has faced corporate officers and directors in the past several years. The evidence of that crisis appeared in the response of insurance companies that issue directors’ and officers’ liability insurance. One study found that renewal premiums rose an average of 362% in 1985.\(^{270}\) Another study indicated that liability insurance premiums rose 506% for a sample of Fortune 1,000 companies from 1985 to 1986.\(^{271}\) Some 20% of the sample experienced increases of 1,000% or

\(^{268}\) West, *supra* note 44, at 642-43.

\(^{269}\) Id. at 643.

\(^{270}\) *Insuring Directors*, Wall St. J., Mar. 21, 1986, at 31, col. 3 (citing a study by Korn/Ferry International).

more. 272 Some observers attributed much of the increase to the Trans Union decision. 273

At the same time, the policies had exclusions that made them worth less to those covered. For example, it was common to exclude coverage for decisions made in response to a hostile takeover bid. 274 Deductibles increased, and policy limits were reduced. 275

Those companies were the lucky ones. Others, especially in troubled industries, found liability insurance impossible to obtain at any price. 276 Troubled banks, oilfield drilling companies, and computer companies all found themselves without coverage. 277 In many cases outside directors resigned. 278 While some companies could offer adequate indemnification agreements, companies facing the risk of bankruptcy could not offer credible promises.

The result was a perceived reduction in the quality of corporate boards. Some companies simply lacked outside directors. Others searched for replacements with low enough net worths so the company could indemnify them. In other cases, where directors remained, some observers felt that director decisions would be more cautious, even when risk-taking was called for. 279

B. The Hidden Cost: The Decision Crisis

The threat of liability will lead directors to approach new opportunities more cautiously, and inevitably will cause them to forgo some opportunities they otherwise would have seized for their firms. These lost transactions cannot be seen and thus cannot be quantified. This cost of

272. Id. Armada Corporation was reported to have had its premium raised from $45,000 to $720,000, an increase of 1600%. Director Insurance Drying Up, N.Y. Times, Mar. 7, 1986, at 29, 31.


275. Director Insurance Drying Up, supra note 272. The article indicated that coverage limits had been reduced to $10 - $30 million from limits of as much as $50 - $150 million the previous year. In the case of Armada Corporation, the deductible increased from $125,000 to $750,000. By 1987 coverage limits were recovering. Firms May Find Insuring Boards Is Getting Easier, supra note 274.

276. Director Insurance Drying Up, supra note 272. By 1987, there was evidence of some easing of the scarcity problem, although for many companies premiums were expected to continue rising, perhaps 10% to 15% in 1987. Firms May Find Insuring Boards Is Getting Easier, supra note 274.


278. Director Insurance Drying Up, supra note 272.

279. Id.
overregulation is typically a hidden cost that is frequently ignored. It is nonetheless real.

Another cost, more apparent, is the increase in transaction costs resulting from a judicial willingness to examine the "rational basis" for every transaction. Lawyers and investment bankers have become regular cast members in what has become a repertory theater, producing and performing paper scripts for the benefit of a very small audience. They are not bit players. Indeed, in some cases they take the leading roles, and they are always paid in a manner befitting their status as stars in the cast.

Similarly, the cost of expected judicial revisiting of corporate commitments, and renegotiation of corporate contracts, makes these contracts less valuable to those dealing with corporations. The price a white knight may be willing to pay for a firm decreases to reflect the uncertainties surrounding the enforceability of the agreement reached.

C. The Legislative Response

Two of the three major decisions that might be credited with precipitating the liability crisis involved challenges to the decisions, rather than claims of director liability. In that light, one might expect reform proposals to focus on the conduct rule, since observation of the conduct rule by directors would presumably protect both the decision and the decision-makers. But so far that has not generally been the case. The only legislation that protects the corporate decision is that which focuses on responses to hostile takeovers.280 The balance of the legislative response focuses exclusively on protecting directors from liability.

Delaware, the traditional leader in corporation law innovations, was the first to respond to these problems. Its approach was contractarian and enabling: to allow corporations to amend their charters to effectively preclude liability for violations of the duty of care.281 But Delaware was

280. These statutes typically expand directors' discretion to consider constituencies other than shareholders in evaluating bids for control. Typical of these statutes is the Indiana version:

A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors which the director considers pertinent.


281. DEL. CODE ANN. tit. 8, § 102(b)(7) provides that articles of incorporation may set forth:
not alone; a majority of states have introduced or passed legislation concerning directors' liability since Trans Union.282 A few states have gone further, and have simply limited director liability for negligence generally. Virginia has provided a cap on directors' and officers' liability.283

Other states have redefined the decision rule, restoring (or going beyond) the business judgment rule. Indiana provides that directors are liable only where a breach of duty constitutes willful misconduct or recklessness.284 Ohio requires clear and convincing evidence of a breach of duty "undertaken with deliberate intent to cause injury to the corporation, or undertaken with reckless disregard for the best interests of the corporation," and extends the business judgment rule's protection to

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(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 7974 of this Title [unlawful payment of dividends], or (iv) for any transaction from which the director derived an improper personal benefit. * * *


284. IND. CODE ANN. § 23-1-35-1(e)(1988) provides:

(e) A director is not liable for any action taken as a director, or any failure to take any action, unless:

(1) the director has breached or failed to perform the duties of the director's office in compliance with this section; and

(2) the breach or failure to perform constitutes willful misconduct or recklessness.
control transactions.\textsuperscript{285} Ohio does permit corporations to opt out of these provisions by charter amendment.\textsuperscript{286}

These statutes will have the ultimate effect of making the duty of care a dead letter as a decision rule for many directors. They also have the effect of making at least some directors' duties a matter of contract rather than of public policy.\textsuperscript{287} That in itself may be the most fundamental change.

VI. CONCLUSION

Changes in language can work subtle changes in substance. That, I believe, is the result of the ALI's treatment of the duties and liabilities of the corporate board. From aspirational language and the literature of managerialist criticism of the modern business corporation the reporters have managed to patch together a complex pattern of subtle changes that would, if left unchallenged, change the role of the modern board. Despite denials that these statements change existing law, the reaction to the few cases that have adopted the ALI's approach to reviewing board actions suggests the contrary. The disruption of established corporate patterns was dramatic, and has been followed by one of the most remarkably consistent and rapid changes in corporation statutes in our history.

The American Law Institute has a long and distinguished history of impartiality and accuracy in its statements of the law. The Corporate Governance Project departs from that tradition in significant ways that call into question the continued viability and credibility of the organization. Ultimately, one must wonder: Can the ALI survive a project that lacks the characteristics that have been the hallmark of the organization?

\textsuperscript{285} OHIO REV. CODE ANN. § 1701.59(c) - (F). Ohio may thus be unique in protecting the decision, as well as the decision-makers. Whether such protection, in the context of defensive tactics against corporate takeovers, is appropriate is another question. My own view is that it is not. Carney, Controlling Management Opportunities in the Market For Corporate Control: An Agency Cost Model, 1988 Wis. L. REV. 385 (forthcoming).

\textsuperscript{286} OHIO REV. CODE ANN. § 1701.59(D) (Anderson 1987).

\textsuperscript{287} Economists, unlike lawyers, have described the corporation as a "nexus for a set of contracting relationships among individuals." Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 310 (1976).