Washington University Law Review

Volume 82 | Issue 3

2004

Structural Bias and the Need for Substantive Review

Julian Velasco
University of Notre Dame Law School

Follow this and additional works at: https://openscholarship.wustl.edu/law_lawreview

Part of the Business Organizations Law Commons

Recommended Citation

Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821 (2004).
Available at: https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

This Article is brought to you for free and open access by the Law School at Washington University Open Scholarship. It has been accepted for inclusion in Washington University Law Review by an authorized administrator of Washington University Open Scholarship. For more information, please contact digital@wumail.wustl.edu.

STRUCTURAL BIAS AND THE NEED FOR SUBSTANTIVE REVIEW

JULIAN VELASCO[*]

One of the fundamental debates in corporate law pits the authority of the board of directors to make business decisions without judicial interference against the accountability of directors to shareholders for their decisions. The business judgment rule attests to the value ascribed to authority by providing only limited judicial review for claims of breach of the duty of care, while the entire fairness test demonstrates the value ascribed to accountability by providing far more exacting scrutiny for claims of breach of the duty of loyalty. In cases involving structural bias, however, neither doctrine is appropriate. Whenever the interests of directors are in conflict with those of shareholders, there is a justifiable concern that directors will pursue their own interests instead of those of shareholders. The interposition of "disinterested" directors is helpful but inadequate because no directors are truly disinterested; at the very least, all directors are inherently interested in issues of accountability. In certain situations involving structural bias, the courts have developed intermediate standards of review for breach of fiduciary duty, but these standards are inadequate. This article proposes and defends a standard that draws upon the insights of both the business judgment rule and the entire fairness test. The proposed standard calls for a moderate review of the merits of directors' decisions in cases involving structural bias. A review of the substantive merit of directors' decisions is necessary to guard against possible abuse by conflicted directors (whether conscious or unconscious), but such review must be limited in order to afford directors sufficient latitude for the exercise of business judgment. Only such an approach can provide the appropriate balance between directorial authority and accountability.

* Associate Professor, Notre Dame Law School. J.D., 1994, Columbia University; B.S., 1991, Georgetown University. The author would like to thank Matthew J. Barrett, Anthony J. Bellia, Jr., Patricia L. Bellia, Lisa L. Casey, Nicole Stelle Garnett, and Rebecca J. Huss for their thoughts and comments, Dwight B. King and Patti Ogden for their expert research assistance, and Kathleen Shields Dugan, Amy Katcherian, William L. Law III, Sonja Redmond, and John F. Wingerter for their excellent student assistance.

Washington University Open Scholarship

TABLE OF CONTENTS

INTRODUCTION 823
I. THE BASIC STANDARDS OF REVIEW 827
  A. *Business Judgment Rule* 828
  B. *Entire Fairness Test* 834
  C. *Shortcomings* 838
II. STRUCTURAL BIAS IN THE COURTS 840
  A. *Judicial Skepticism* 841
  B. *Endorsement Via Intermediate Standards of Review* 845
    1. *Hostile Takeovers* 846
    2. *Derivative Litigation* 849
    3. *Disinterested Approval* 851
III. A CLOSER LOOK AT STRUCTURAL BIAS 853
  A. *As Implicit Conspiracy* 856
  B. *As Relationship—Friendship and Collegiality* 858
  C. *As Psychological Phenomenon—Ingroup Bias* 860
  D. *Critique of Structural Bias* 865
IV. REVIEW FOR SUBSTANTIVE REASONABLENESS 870
  A. *Lessons Learned* 871
    1. *Need for Substantive Review* 871
    2. *Need for Latitude* 874
  B. *Substantive Reasonableness* 876
    1. *Outlines of Reasonableness* 876
    2. *Hostile Takeover and Derivative Litigation Standards Distinguished* 879
  C. *Shortcomings* 883
V. APPLICATION 887
  A. *Hostile Takeovers* 888
  B. *Derivative Litigation* 893
  C. *Executive Compensation* 904
  D. *Director Exculpation Statutes* 913
CONCLUSION 916

INTRODUCTION

One of the fundamental debates in corporate law pits the authority of boards of directors to make business decisions without judicial interference against the accountability of directors to shareholders for their decisions.[1] These competing values are reflected in the courts' treatment of directors' fiduciary duties:[2] the business judgment rule attests to the value ascribed to authority by providing only limited judicial review for claims of breach of the duty of care, while the entire fairness test demonstrates the value ascribed to accountability by providing far more exacting scrutiny for claims of breach of the duty of loyalty.[3] Unfortunately, there are many situations in which the competition between these two values yields no obvious victor. In such situations, neither standard of review provides an adequate judicial response to claims of breach of fiduciary duty.

Courts have attempted to respond to such situations in a variety of ways, but have not developed a comprehensive approach to the problem.

---

1. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004) [hereinafter Bainbridge, *Abstention Doctrine*]; *see also* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 242, 207–08 (2002) [hereinafter BAINBRIDGE, CORPORATION LAW].

2. Delaware courts generally speak of a "triad of fiduciary duties: good faith, loyalty, [and] due care." Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 (Del. 1995) (citation omitted). Not everyone agrees that good faith is on an equal footing with care and loyalty. *See, e.g.*, *In re* Gaylord Container Corp. S'holders. Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (arguing good faith is subsidiary requirement of duty of loyalty). At best, the duty of good faith is the least well developed of the three. For an interesting argument that the duty of good faith is an emerging body of law, see Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004).

3. In Delaware, the two standards have been joined by innovations that are—or, at least, originally were—fairly unorthodox. All claims of breach of fiduciary duty initially are protected by the presumption of the business judgment rule. If a plaintiff can establish a breach of fiduciary duty, whether the duty of loyalty or the duty of care, then the entire fairness test is invoked. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

This intermingling of the standards has been the subject of criticism. *See, e.g.*, William T. Allen, et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 874–78 (2001); Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625 *passim* (2000). However, the effect of these developments is not as great as might be thought. Because the burden of proof for overcoming the business judgment rule's presumption is much greater in cases involving the duty of care than those involving the duty of loyalty, it is still true, as a general matter, that duty of care cases are reviewed under the business judgment rule (because the burden of proof cannot be overcome in most cases) and that duty of loyalty cases are reviewed under the entire fairness test (because the burden of proof can be overcome in many cases). In any event, these complications do not necessarily interfere with the operation of an intermediate standard of review. Instead, an intermediate standard merely would have to be positioned properly between the business judgment rule and the entire fairness test. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (characterizing intermediate standard of review as threshold inquiry, "before the protections of the business judgment rule may be conferred").

Washington University Open Scholarship

As a result, the development of the corporate law on fiduciary duties has been chaotic. Intermediate standards of review have multiplied, but without much effect. The business judgment rule has been exalted over the entire fairness test, and accountability has been sacrificed in the name of directorial authority. Whether or not this state of affairs has caused or otherwise contributed to the recent corporate scandals, it has left shareholders under-protected from the abuses of their fiduciaries.

To restore order in this area of law, courts must recognize and address the central problem: structural bias. The term "structural bias" generally refers to the prejudice that members of the board of directors may have in favor of one another and of management.[4] It is said to be the result of the "common cultural bond" and "natural empathy and collegiality" shared by most directors,[5] the "economic[] or psychological[] dependen[cy] upon or tie[s] to the corporation's executives, particularly its chief executive,"[6] and the "process of director selection and socialization, which incumbent management dominates."[7] Because of structural bias, directors may—or, at least, may be tempted to—act in the interests of each other and of management rather than in the interests of shareholders. Structural bias is not an issue with respect to most business decisions. However, it is an inescapable problem whenever directors stand to benefit at the expense of shareholders. This is true even if the conflict of interest does not rise to the level of self-dealing,[8] such as when a colleague has a financial conflict but does not take part in the decision making, or when the benefit is

---

4. For other definitions of structural bias, see Beam v. Stewart, 845 A.2d 1040, 1050–51 (Del. 2004) ("[The] 'structural bias' argument . . . presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking."); Miller v. Register and Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983) ("[T]he 'structural bias' approach . . . suggests that it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences which flow from the directors who appoint them."); James D. Cox & Donald E. Schwartz, *The Business Judgment Rule in the Context of Termination of Derivative Suits by Independent Committees*, 61 N.C. L. REV. 541, 542–43 (1983) (describing structural bias as "predisposition toward the defendant because the members who serve on the special litigation committee have a common cultural bond with the defendants on whom they are passing judgment"); and Mark A. Underberg, Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 601 n.14 (1980) (describing structural bias as "inherent prejudice . . . resulting from the composition and character of the board of directors [and management]").

5. James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 962.

6. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 145 (1976).

7. John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 283 (1981).

8. *A fortiori*, it is true when there is self-dealing. However, the remedy in such situations is the entire fairness test.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

considered too intangible, indirect, or speculative to compromise directors' impartiality. Derivative litigation and hostile takeovers are two common examples. In such situations, there is a legitimate concern that directors may take actions that promote their own interests and those of management rather than the interests of shareholders. Although such concerns, without more, may not warrant the application of a standard as severe as the entire fairness test, they do undermine confidence in the applicability of a standard as deferential as the business judgment rule. In cases where neither standard is appropriate, the solution is an effective intermediate standard of review.

The courts have developed a number of inconsistent standards[9] when an appropriate theoretical framework would have revealed the possibility and benefits of a common approach. A good intermediate standard of review should be derived from the two extreme standards it seeks to mediate. Both the business judgment rule and the entire fairness test reflect the corporate law wisdom of the ages, so the intermediate standard must draw on the strength of their fundamental insights. However, neither basic standard is adequate to deal with structural bias, so the intermediate standard must overcome their shortcomings.

This Article will propose an intermediate standard of review for cases involving structural bias that will do just that.[10] Because of the directors' conflicts of interest, the appropriate standard must allow courts to look into the substance of directors' decisions; however, because of the need for the exercise of business judgment, it must afford directors significant latitude. The proposed standard calls for an inquiry into the substantive reasonableness of directors' decisions: those that are unreasonable should be considered a breach of fiduciary duty while those that fall within a range of reasonableness should be upheld. This standard is neither wholly unfamiliar nor a mere restatement of an existing standard. A review for substantive reasonableness is the best way to bridge the gap between the business judgment rule and the entire fairness test in situations that call for the application of neither extreme standard.

Part I lays a foundation by exploring the business judgment rule and the entire fairness test. It describes the two standards, considers the justifications commonly given for each, and examines their relative

9. *See, e.g.*, Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994) (disinterested shareholder approval of transaction with controlling shareholder); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (takeover defense); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (derivative litigation); *see also infra* Part II.B.

10. For another example of a similar endeavor, see Allen et al., *supra* note 3.

Washington University Open Scholarship

weaknesses. It argues that the two doctrines provide complementary insights that are equally fundamental to corporate law: that, as a general matter, the interests of shareholders and directors are aligned such that directors can be trusted and need not be policed very closely, but that, when their interests conflict, directors cannot be trusted and must be subject to careful judicial scrutiny. Thus, the two standards represent opposite sides of the same coin. They are the twin pillars of enforcement of fiduciary duties in corporate law that provide balance between the competing values of authority and accountability.

Part II examines how courts have dealt with the issue of structural bias. It begins by examining cases in which courts have resisted the theory. Rather than accepting structural bias as a conflict of interest inherent in certain situations, courts often have demanded proof of actual bias in directors' decisions. Part II then turns to cases that have been more accepting of the theory of structural bias, if not the title. It demonstrates that courts have responded in an ad hoc manner, and argues that a common solution would be a better approach.

Part III takes a closer look at structural bias. It argues that conflicts of interest are more problematic than currently recognized under the duty of loyalty. It proposes three paradigms for understanding structural bias: first, an implicit conspiracy among directors to benefit themselves; second, the effect of relationships which cause friends and colleagues to favor each other over strangers; and third, a psychological phenomenon—ingroup bias—that causes members of the board of directors to show favoritism towards other members of the same group. Although such conflicts may not rise to the level of self-dealing, they do undermine confidence in directors' decisions. Thus, although none of these paradigms may make a strong case for the application of the entire fairness test, all three militate against the application of the business judgment rule.

Part IV proposes a new intermediate standard of review for cases involving structural bias. It begins by arguing that the appropriate approach would strike a balance between the deference of the business judgment rule and the rigor of the entire fairness test, and that a moderate review of the substance of directors' decisions best bridges that gap. It then proposes a new standard: review for substantive reasonableness. After delineating the contours of the proposed standard and distinguishing it from existing standards that sound similar, it addresses certain practical concerns that may be raised against it.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

Finally, Part V attempts to apply the new standard to some basic situations in order to demonstrate its impact. It begins by addressing two situations commonly accepted as involving structural bias: hostile takeovers and derivative litigation. It then addresses an additional situation in which structural bias is a problem: executive compensation decisions. Finally, it considers the applicability of director exculpation statutes to situations involving structural bias. The goal of Part V is to demonstrate that the proposed standard is not nearly as radical as it may seem at first.

I. THE BASIC STANDARDS OF REVIEW

The twin pillars of enforcement of fiduciary duties in corporate law are the business judgment rule and the entire fairness test. These two core doctrines stand in stark contrast to each other because of the radically divergent level of judicial scrutiny they provide. The leniency of the business judgment rule embodies the principle of directorial authority, while the strictness of the entire fairness test embodies the principle of directorial accountability. Despite the tension between them, the two are actually highly complementary doctrines. Each provides insights that are central to modern corporate law.

Often, it is assumed that the business judgment rule is the lone foundation of corporate law.[11] This is as unfortunate as it is wrong. The entire fairness test is no less fundamental or essential.[12] The two standards "are, so to speak, of equal dignity,"[13] and neither has a claim to primacy over the other. The deference of the business judgment rule is justifiable only because of, and also makes possible, the rigor of the entire fairness test. The legitimacy of either depends upon the other. Thus, an appropriate understanding of both standards—including their insights as well as their limitations—is indispensable to the proper formulation of an intermediate standard of review capable of dealing with the issue of structural bias.

---

11. *See, e.g.*, Allen et al., *supra* note 3, at 867 (arguing that Delaware courts "link all the disparate review standards together by using the business judgment rule as the medium"); Johnson, *supra* note 3, at 625 (arguing that "Delaware courts both wrongly formulate the business judgment rule and unsoundly make it the centerpiece of corporate fiduciary analysis").

12. This is true even under the reorganization of corporate law doctrine effected by *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994). *See supra* note 3. The business judgment rule may presume compliance with fiduciary duties, but the entire fairness test is the result of a rebuttal of that presumption.

13. Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963) (setting forth the "equal dignities rule" of form over substance in corporate law).

Washington University Open Scholarship

A. Business Judgment Rule

Despite its history and pedigree,[14] the business judgment rule cannot be reduced easily to a written formula.[15] According to the Delaware courts, it is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[16] This description is inadequate at best. Although the business judgment rule can be said to provide "a powerful presumption" in favor of directors,[17] it does much more. It is better understood as either a standard of review or a policy of non-review.[18]

---

14. *See* 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 7 (1998) ("For over a century and a half, the business judgment rule has been the primary means by which courts have reviewed decisions by corporate directors concerning ordinary day-to-day business matters."); FRANKLIN A. GEVURTZ, CORPORATION LAW 278 (2000) ("The business judgment rule traces its roots back around 170 years.") (footnote omitted); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 93 (1979) ("[T]he business judgment rule [has been] a common law principle of corporate governance that has been part of corporate law for at least 150 years."); Johnson, *supra* note 3, at 639 ("Although the phrase 'business judgment rule' apparently was not used by the Delaware Chancery Court until 1959, the phrase 'business judgment'—and the concept of the rule itself—had been in use for several decades.") (footnotes omitted).

15. *See* GEVURTZ, *supra* note 14, at 279.

> A difficulty with the business judgment rule occurs, however, when courts and writers go beyond the general concept of judicial restraint and attempt to inject specific content into the rule. Immediately, a lack of consensus emerges as to exactly what the business judgment rule really is. An example of this difficulty occurred during the drafting of the 1984 revision of the Model Business Corporation Act. The drafters of the 1984 revision initially thought it would be a good idea to include the rule as part of the Act. This process broke down, however, when the drafters could not reach a consensus on a formulation of the rule. As one of the participants explained, "we are saying that there is a business judgment rule, that we know what it is and when it should be applied, but we can't define it."

Id. (footnotes omitted); *see also* 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01, Comment to § 4.01(c) cmt. a (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE] ("Confusion with respect to the business judgment rule has been created by the numerous varying formulations of the rule and the fact that courts have often stated the rule incompletely or with elliptical shorthand references."); BAINBRIDGE, CORPORATION LAW, *supra* note 1, at 242 ("[I]n many ways, [the business judgment rule] remains poorly misunderstood. In part, this is because the doctrine is neither straightforward nor even, in some respects, well developed."); *cf.* Johnson, *supra* note 3, at 625 ("Delaware courts both wrongly formulate the business judgment rule and unsoundly make it the centerpiece of corporate fiduciary analysis.").

16. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

17. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). *But see* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1353 (1993) ("The presumption of the business judgment rule is not a presumption in the ordinary evidentiary sense of allocating the burden of proof.").

18. *See* BAINBRIDGE, CORPORATION LAW, *supra* note 1, at 243 ("Two basic conceptions of the business judgment rule compete in the case law. One treats the rule as a standard of review . . . . The

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

Many alternative formulations of the business judgment rule have been proposed.[19] The varying formulations reflect the reality that the business judgment rule consists of two separate components: one dealing with process and one dealing with substance.[20] The process component requires that breaches of the fiduciary duty of care not be reviewed under a negligence standard, but something much less demanding; in Delaware, the standard is gross negligence.[21] Thus, it could be said that the business judgment rule "presumption" is strong enough that evidence of ordinary negligence is insufficient to rebut it. The substance component, on the other hand, requires that the merit of a business decision not be reviewed at all, except in the most extreme circumstances. Courts will not hold directors liable for decisions that are objectively unwise, unreasonable, or

---

other treats the rule as an abstention doctrine that creates a presumption against judicial review of duty of care claims."). For the view that the business judgment rule serves as a standard of review, see, for example, *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003); 2 MODEL BUS. CORP. ACT § 8.31 official cmt., at 8-193 (2002); 3A WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1036, at 35; Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 440–42 (1993). For the view that the business judgment rule serves as a policy of non-review, see, for example, Bainbridge, *Abstention Doctrine*, *supra* note 1, *passim*; Allen et al., *supra* note 3, at 870 ("[T]he 'business judgment rule' is not, functionally speaking, a standard of review at all. Rather, it is an expression of a policy of non-review of a board of directors' decision . . . ."); Johnson, *supra* note 3, at 625 ("The business judgment rule . . . is better understood as a narrow-gauged policy of *non-review* . . . ."). *See also* 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 15, § 4.01, Comment to § 4.01(c) cmt. a ("Although courts have not expressed it this way, the business judgment rule has offered a safe harbor for directors or officers who make honest, informed business decisions that they rationally believe are in the best interests of their corporations.").

19. *See, e.g.*, 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 15, § 4.01(c); 2 MODEL BUS. CORP. ACT § 8.31, official cmt., at 8-197 (2002) ("In basic principle, a board of directors enjoys a presumption of sound business judgment and its decisions will not be disturbed (by a court substituting its own notions of what is or is not sound business judgment) if they can be attributed to any rational business purpose.") (citation omitted). For additional formulations, see 1 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 2.01, at 2-1 to -5 (7th ed. 2003).

20. *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 302 (1994) ("There are a number of variations on this process-versus-substance theme. All have in common, however, the notion that the business judgment rule calls for less judicial scrutiny of the merits of the directors' decision than of the process the directors used in arriving at the determination.").

21. *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ("We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence."). *But see* Litwin v. Allen, 25 N.Y.S.2d 667, 678 (1940) ("[D]irectors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence.").

Although Delaware courts purport to apply a gross negligence standard, many have argued that courts sometimes apply a pure negligence standard. *See, e.g.*, Allen et al., *supra* note 3, at 872–74.

Washington University Open Scholarship

even stupid[22]—unless, perhaps, a decision can be shown to be utterly irrational or amounting to waste.[23] Thus, it could be said that the business judgment rule "presumption" is nearly irrebuttable with respect to substance. For this reason, it is fair to say that the business judgment rule focuses primarily on the directors' decision-making process.[24]

However defined, the business judgment rule universally is acknowledged to demonstrate great deference to directors' business decisions and to provide a strong shield from liability for those decisions. The business judgment rule affords corporate directors unique protection from civil liability for the consequences of their actions.[25] This special treatment demands justification.

The justifications for the business judgment rule are well-known. They often are said to begin with the statutory language.[26] Section 141(a) of the Delaware General Corporate Law, for example, provides that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . . "[27] Thus, it is the board of directors that should be making business decisions, not the shareholders who would challenge their decisions, and certainly not the courts who would evaluate them.[28]

22. *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("As for . . . 'substantive due care,' we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only.") (footnote omitted); *In re* Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a . . . decision [is] substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance the corporate interests.").

23. *See Eisner*, 746 A.2d at 264 ("Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.") (footnotes omitted).

24. Some would have the business judgment rule focus entirely on process. *See, e.g.*, Allen et al., *supra* note 3, at 890–93; Bainbridge, *Abstention Doctrine*, *supra* note 1, at 99; Johnson, *supra* note 3, at 632–33.

25. *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) ("Whereas an automobile driver who makes a mistake in judgment . . . injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment . . . will rarely, if ever, be found liable for damages suffered by the corporation.").

26. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 *Del.C.* § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.").

27. DEL. CODE ANN. tit. 8, § 141(a) (2001).

28. *See Van Gorkom*, 488 A.2d at 872 ("The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.") (citation omitted); *see also* Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) ("[B]y definition the responsibility for business judgments must rest with the corporate directors; their individual

A second rationale for the business judgment rule is based on the fact that business decisions are inherently risky. Directors often have to make important decisions with imperfect information. The quality of the decision cannot necessarily be determined by the result that follows. Second-guessing is especially dangerous under such circumstances.[29] Courts, in particular, are said to be ill-equipped to make, or even to review, business decisions.[30] Some even argue that courts are "radically incompetent" in this regard.[31]

In addition, imposing liability on directors for poor business decisions would be counterproductive in several respects. It might discourage people from serving as directors because the potential liability would far exceed the compensation that would be received for such service.[32] It also might discourage directors from engaging in risky behavior, even when it would be in the interests of shareholders to do so.[33]

---

capabilities and experience peculiarly qualify them for the discharge of that responsibility.").

29. *See Joy*, 692 F.2d at 886. The *Joy* court stated:

> [C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Id. See generally Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998); *see also id.* at 619–23.

30. *See* Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) ("'Courts are ill-fitted to attempt to weigh the "adequacy" of consideration under the waste standard or, *ex post*, to judge appropriate degrees of business risk.'") (quoting Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997)); Cuker v. Mikalauskas, 692 A.2d 1042, 1046 (Pa. 1997) ("[The business judgment] doctrine prevents courts from becoming enmeshed in complex corporate decision-making, a task they are ill-equipped to perform.") (citation omitted); Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1262 (Conn. 1994) ("Courts recognize that managers have both better information and better incentives than they . . . . Not only do businessmen know more about business than judges do, but competition . . . provides sufficient punishment for businessmen who commit more than their share of business mistakes.") (citation omitted); Daniels v. Thomas, Dean & Hoskins, Inc., 804 P.2d 359, 367 (Mont. 1990) ("Judges are not business experts and therefore should not substitute their judgment for the judgment of the directors.") (citation omitted); *Auerbach*, 393 N.E.2d at 1000 ("[T]he business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments.").

31. Bainbridge, *Abstention Doctrine*, *supra* note 1, at 119–20 (quoting Eric A. Posner, *A Theory of Contract Law under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 754 (2000)).

32. *See* Air Line Pilots Ass'n, Int'l v. UAL Corp., 717 F. Supp. 575, 582 (N.D. Ill. 1989), *aff'd*, 897 F.2d 1394 (7th Cir. 1990) ("It would be considerably more difficult to recruit directors to serve on corporate boards if their business decisions were subject to substantive scrutiny. The business judgment rule encourages competent individuals to become directors who otherwise might decline for fear of personal liability.").

33. *See In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967 n.16 (Del. Ch. 1996) ("If those in charge of the corporation are to be adjudged personally liable for losses . . . based upon what . . . persons of ordinary or average judgment . . . regard as 'prudent[,]' 'sensible[,]' or even 'rational,'

Washington University Open Scholarship

Furthermore, imposing liability on directors for bad decisions would run counter to a standard rationale for the imposition of liability: the spreading of costs. Rather than taking a large loss that befalls one or a few individuals and imposing a fractional cost on the public generally, director liability would take small losses from a large number of shareholders and impose huge aggregate liability on a small group of directors.[34]

Finally, shareholders can be said to have assumed the risk of bad business decisions in several respects. First, shareholders voluntarily invest in risky assets: rather than invest in risk-free assets, such as U.S. government bonds, they invest in equity securities in order to achieve a higher rate of return.[35] It would be inappropriate for shareholders to complain that things did not turn out as hoped. In addition, shareholders have the ability to reduce their risk through diversification—an opportunity not generally available in other circumstances.[36] Thus, litigation concerning the management of a business is not as critical as other types of litigation. Moreover, shareholders elect directors to manage the corporation on their behalf. In doing so, they should be deemed to

---

such persons will have a strong incentive at the margin to authorize less risky investment projects."); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[D]irectors will tend to deviate from this rational acceptance of corporate risk *if* in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to *ex post facto* claims of derivative liability for any resulting corporate loss."); *Joy*, 692 F.2d at 886 ("[B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions.").

34. *See* Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 575.

> In most cases, liability for negligence operates to shift the loss from a single human victim and spread it, by means of insurance and doctrines such as respondeat superior, across a larger, more diversified group. At least in the case of larger, publicly held corporations, directors' liability has just the opposite effect. . . . Imposing liability on the directors serves to re-concentrate [a] loss on a small handful of individuals.

Id. Of course, to the extent that directors and officers insurance is available, this negative impact is reduced.

35. *See Joy*, 692 F.2d at 885 ("[S]hareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers."); *Gagliardi*, 683 A.2d at 1052 ("Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests . . . will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.").

36. *See Joy*, 692 F.2d at 886 ("Shareholders can reduce the volatility of risk by diversifying their holdings. . . . Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protections to shareholders who refuse to reduce the volatility of risk by not diversifying."); *Gagliardi*, 683 A.2d at 1052 ("Shareholders can diversify the risks of their corporate investments.").

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

accept the judgment of those directors—and to assume the risk of bad decisions made by those directors.[37]

Of course, it can be argued that none of the reasons given truly justifies the existence of the business judgment rule because most, if not all, are applicable in many other contexts as well:[38]

> Can anyone seriously argue that surgeons in the operating room, lawyers in the midst of a heated trial, or accountants up against a closing deadline are not also called upon to make snap judgments in response to circumstances that may be difficult to recreate [sic] in a courtroom years later? Nonetheless, our legal system is quite comfortable relying on the device of litigation to review, invariably with the benefit of hindsight, the quality of these professionals' performances and to assess damages, often in the millions of dollars, when those performances are found wanting. Why should directors be any different?[39]

There is significant merit to the argument.

However, there does seem to be something qualitatively different in the business context. In most other situations, people generally would prefer to avoid risk, while in the business context, investors often are eager to accept more risk in order to increase their expected rate of return.[40] Moreover, in most other situations, people are seeking to avoid a loss or even bodily harm, while in the business context, investors generally are investing their surplus funds in the anticipation of profit.[41] Thus, the

---

37. *See In re* Caremark International Inc. Derivative Litigation, 698 A.2d 959, 968 (Del. Ch. 1996) ("If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors."); *Joy*, 692 F.2d at 885 ("Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.").

38. *See generally* Gevurtz, *supra* note 20, at 304–21. *Cf.* Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 590 (1994) (concluding that "there are indeed justifiable reasons for courts to treat business decisions differently than medical decisions").

39. Davis, *supra* note 34, at 581.

40. *See supra* note 35 and accompanying text. It is true that tort plaintiffs often accept risk voluntarily. For example, medical patients are made to understand that surgery necessarily involves risk. However, there is a categorical difference between a patient and an investor. A patient generally is required to undergo surgery. Although some surgery is elective, it is rarely optional in the sense that an investment decision is optional: the investor, unlike the patient, has a risk-free investment alternative. Moreover, a patient would prefer to reduce the risk associated with any given surgery to the fullest extent possible. An investor, on the other hand, may be willing to accept any amount of risk as long as the expected return is commensurate.

41. The doctrine of limited liability ensures that an investor can decide freely how much to put at risk with any investment decision. The same is not true in many other circumstances, such as surgery,

Washington University Open Scholarship

arguments based on risk (and assumption of risk) are more substantial in the business context than in other situations.

The key insight that drives the business judgment rule is this: as a general matter, directors can be trusted and need not be policed very closely. By and large, the interests of the directors and the shareholders are aligned: they both want the business to prosper.[42] Disagreements, for the most part, are about the best way of achieving that goal. It is likely that litigation on substantive decisions, and even on duty of care issues, would be about matters on which reasonable people would disagree. In light of the principles discussed above, there is no good reason to waste scarce judicial resources on such disputes. This is especially true given that neither judges nor shareholders are likely to be capable of making better decisions than the professionals charged with running the business. It is only when there are conflicts of interest that the courts need to get involved.

B. Entire Fairness Test

If the key insight of the business judgment rule is that directors generally can be trusted, the key insight of the entire fairness test is that this is not always so.[43] Although the interests of directors usually are

---

where a person's life can be at risk.

42. *See* Allen et al., *supra* note 3, at 875 ("[A] board that is not conflicted is motivated to achieve the highest price the market will permit. Because in those circumstances the board's interests and the interests of the shareholders are aligned, there is no reason for courts to engage in a substantive review of the board's decision."); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117 (1965) ("Generally speaking, managers' incentives and interests coincide with those of their shareholders in every particular except one: they have no incentive, as managers, to buy management services for the company at the lowest possible price.").

Agency theory suggests that any agent may be tempted to act in her own interests rather than those of the principal. In corporate law, this is generally understood to apply to officers, who may prefer their own interests to those of shareholders. Thus, officers would prefer greater compensation and job security, and less pressure and accountability, than shareholders would want them to have. Under agency theory, the role of directors is to monitor officers. One of their most important functions is to implement executive compensation packages that re-align the interests of officers and shareholders. However, directors themselves are not immune to the agency problem, making perfect resolution impossible. *See generally* Michael C. Jenson & William H. Meckling, *Theory of the Firm: Ownership, Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); *see also* GEVURTZ, *supra* note 14, at 229–41.

Nevertheless, corporate law generally assumes that directors can be trusted. Various justifications can be given for this, ranging from the discipline of market forces to directors' integrity. In any event, the problem is not so much the law's willingness to assume that, absent conflicts of interest, directors are willing and able to act in the interests of shareholders. Rather, the problem is identifying conflicts that could upset this assumption. This issue is confronted *infra* Part III.

43. *See* Thorpe v. CERBCO, Inc., 676 A.2d 436, 443 n.9 (Del. 1996) ("The premise of the entire fairness test is that the business judgment rule is inapplicable where self-interest may have colored

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

aligned with those of the shareholders, there are times when their interests conflict. In those situations, the deference afforded to directors by the business judgment rule is wholly inappropriate.[44] Thus, when a plaintiff can establish a cognizable duty of loyalty issue, the protections of the business judgment rule are lost, and the directors' actions are reviewed under the entire fairness test.

The entire fairness test is far more demanding than the business judgment rule.[45] It requires the directors to prove that the transaction in question was entirely fair to the corporation and its shareholders.[46] Like

---

directors' actions."); *see also* Allen et al., *supra* note 3, at 874–75 ("Claimed breaches of the duty of loyalty . . . [are] reviewed under a far more exacting standard—entire fairness. . . . Where . . . a majority of the board is conflicted . . . it cannot be presumed that the board will be motivated to achieve the highest transaction price the market will permit.").

44. *See* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) ("Whatever its merit, however, the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases, *e.g.*, in which the corporate decision . . . is tainted by a conflict of interest . . . ."); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. 1986) ("This unwillingness to assess the merits (or fairness) of business decisions of necessity ends when a transaction is one involving a predominately interested board . . . In that setting there is no alternative to a judicial evaluation . . . other than the unacceptable one of leaving shareholders unprotected."); Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 663 (Del. 1952) ("Human nature being what it is, the law, in its wisdom, does not presume that directors will be competent judges of the fair treatment of their company where fairness must be at their own personal expense."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."); David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430–31 (Del. Ch. 1968) ("[W]hen the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are on both sides, then the presumption and deference to sound business judgment are no longer present."); *see also* 2 MODEL BUS. CORP. ACT § 8.60 Subchapter F, introductory cmt., at 8-372 (2002) ("The law regulates interest-conflict transactions because experience shows that people do often yield to the temptation to advance their self-interests and, if they do, other people may be injured. That contingent fear is sufficient reason to warrant caution and to apply special standards and procedures to interest-conflict transactions."); Bainbridge, *Abstention Doctrine*, *supra* note 1, at 122–23 ("Despite the limitations of judicial review, rational shareholders would prefer judicial intervention with respect to board decisions . . . tainted ['by considerations other than shareholder wealth, as where the directors engage in self-dealing or seek to defraud the shareholders']. The affirmative case for disregarding honest errors simply does not apply to intentional misconduct.") (footnotes omitted).

45. "Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome . . . ." *AC Acquisitions Corp.*, 519 A.2d 103, 111 (Del. Ch. 1986). *But see infra* note 137 and accompanying text.

46. Pepper v. Litton, 308 U.S. 295, 306 (1939) ("Their dealings with the corporation are subjected to rigorous scrutiny and . . . the burden is on the director . . . not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."); Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply . . . exacting scrutiny to determine whether the transaction is entirely fair to the stockholders."); Nixon v. Blackwell, 626 A.2d 1366, 1375–76 (Del. 1993) ("[T]he defendants are on both sides of the transaction. For that reason, . . . the entire fairness test applies . . . . Accordingly, defendants have the burden of showing the entire fairness of those transactions.");

Washington University Open Scholarship

the business judgment rule, the entire fairness test has both a procedural and a substantive component. The Delaware Supreme Court has described the entire fairness test as follows:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. . . . However, the test for fairness is not a bifurcated one as between fair dealing and fair price. All aspects of the issue must be examined as a whole, since the question is one of entire fairness.[47]

Nevertheless, the court recognized that "in a non-fraudulent transaction . . . price may be the preponderant consideration outweighing other features,"[48] thereby making substantive review an essential part of the entire fairness test.

The deference that is the hallmark of the business judgment rule is entirely absent under the entire fairness test.[49] Not only do directors bear the burden of proof, but they must justify both their decision making process and the substance of their decisions. The business judgment rule and the entire fairness test could not be much more divergent. This difference also demands justification.

The duty of loyalty always has been taken very seriously by the courts. Whether or not their actions always have been correspondingly tough,[50] courts have used the strongest language in describing and defending the

---

Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."); Strassburger v. Earley, 752 A.2d 557, 570 (Del. Ch. 2000) ("Under [the entire fairness test], where the controlling shareholder and the directors stand on both sides of the transaction, they bear the burden to demonstrate that the transaction was entirely fair to the corporation and the minority stockholders, both as to process and price.").

47. *Weinberger*, 457 A.2d at 711 (citations omitted).

48. *Id.*

49. *See Nixon*, 626 A.2d at 1376 ("The entire fairness analysis essentially requires 'judicial scrutiny.' In business judgment rule cases, an essential element is the fact that there has been a business decision made by a disinterested and independent corporate decisionmaker. When there is no independent corporate decisionmaker, the court may become the objective arbiter.") (citations omitted).

50. *See infra* note 137 and accompanying text.

duty of loyalty. They speak of "the punctilio of an honor the most sensitive,"[51] "the most scrupulous observance of [one's] duty,"[52] and "the utmost good faith and the most scrupulous inherent fairness."[53] It should not be surprising, then, that there should be a heightened standard of review in corporate law for breaches of the duty of loyalty.

When their interests conflict, directors cannot be trusted to pursue the interests of shareholders over their own.[54] Even assuming directors would not be dishonest by consciously favoring their own interests, their bias may make them unable to pursue shareholder interests as zealously as the shareholders deserve.[55] This would seem to be cause to prohibit, to the fullest extent possible, conflict of interest situations such as transactions between the company and its directors. In fact, the law originally followed such an approach.[56] However, because such transactions are not always contrary to the interests of the shareholders, there was reason to find a way to permit beneficial transactions. Among the means selected was the entire fairness test, under which transactions would be permitted if the directors could prove that the transaction was entirely fair to the corporation and its shareholders.[57]

---

51. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (addressing fiduciary duty of loyalty among partners).

52. Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

53. *Weinberger*, 457 A.2d at 710.

54. *See* Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 663 (Del. 1952) ("Human nature being what it is, the law, in its wisdom, does not presume that directors will be competent judges of the fair treatment of their company where fairness must be at their own personal expense."); GEVURTZ, *supra* note 14, at 325 ("[T]he fundamental problem with conflict-of-interest transactions is that we do not trust individuals with a personal financial stake at odds with the corporation's to put the corporation's interest ahead of their own.").

55. *See* Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) ("A director's interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision. 'In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the . . . personal consequences resulting from the decision.'") (quoting Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)); *Guth*, 5 A.2d at 510 (stating that entire fairness test is "derived from a profound knowledge of human characteristics and motives"); W. States Life Ins. Co. v. Lockwood, 135 P. 496, 500 (1913) ("It matters not that the officer is entirely free from any intent to injure the corporation in the slightest degree, acting in fact in the highest good faith throughout, or that his actions really advantage the corporation.").

56. "In 1880, it could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction." Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966); *cf.* Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655 (1992).

57. Another option would be to submit the matter to disinterested directors and/or shareholders. *See infra* notes 72–74 and accompanying text.

Washington University Open Scholarship

Courts are not well-suited to making business decisions; that is the job of directors.[58] However, conflicted directors are not well-suited to making business decisions in the interests of shareholders, either.[59] Moreover, it is difficult to have confidence that conflicted directors can overcome their substantive bias by any procedural means because the arm's length bargaining process cannot effectively be re-created when directors are on both sides of the transaction.[60] Thus, the supervision of the courts often is the only available alternative.[61]

Finally, it bears emphasis that the courts are not exactly imposing their own business judgment under the entire fairness test. Rather, they simply are demanding strong justification for a given transaction.[62] That exercise is within the core competence of the courts.

C. Shortcomings

Occupying, as they do, the two extreme positions in corporate law, both the business judgment rule and the entire fairness test suffer from significant shortcomings. Although each has its proper role, neither should be employed too broadly or without caution. Excessive use of either standard could lead to disastrous results.

The main shortcoming of the entire fairness test is that it is too strict.[63] There could be plenty of transactions or other business decisions that would be, in fact, entirely fair to the corporation and its shareholders but with respect to which the directors would be unable to carry their burden of proof. For the reasons discussed with respect to the business judgment rule, the substance of business decisions is often difficult to defend.

---

58. *See supra* notes 28–31 and accompanying text.

59. *See supra* note 44 and accompanying text.

60. *Cf.* Pepper v. Litton, 308 U.S. 295, 306–07 (1930) ("The essence of the test [of intrinsic fairness] is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."); *see also infra* notes 72–74 and accompanying text (discussing delegation of decision making to committees of disinterested directors).

61. *See* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) ("[W]hen a transaction is one involving a predominately interested board with a financial interest in the transaction adverse to the corporation . . . there is no alternative to a judicial evaluation of the fairness of the terms of the transaction other than the unacceptable one of leaving shareholders unprotected."); GEVURTZ, *supra* note 14, at 322 ("The various rationales for the business judgment rule . . . largely disappear when dealing with conflict-of-interest transactions. The idea that directors . . . are more likely to reach a better business decision than the courts presupposes a situation in which we can trust the directors to act in the best interest of the corporation."); *see also supra* note 44 and accompanying text. *But see infra* notes 72–74 and accompanying text.

62. *See supra* note 46 and accompanying text; *cf. infra* notes 266–70 and accompanying text.

63. *See supra* notes 46–53 and accompanying text. *But see infra* note 137 and accompanying text.

Second-guessing is not the best way to assess the merits of a business decision. While it may be necessary to do so at times, it would be inappropriate to expand the application of the entire fairness test too broadly.

Moreover, if the entire fairness test were employed too frequently, it would consume a great deal of judicial resources.[64] It also would subject a great number of business decisions to a form of review—i.e., judicial—that is acknowledged to be highly imperfect.[65] Thus, prudence dictates that the entire fairness test ought not to be over-extended.

However, the business judgment rule is imperfect as well. Its main shortcoming is the exact opposite of the entire fairness test's: it is too lenient. In theory, at least, only grossly negligent conduct and wholly irrational decisions would fail to pass muster.[66] Surely there have been, throughout the years, countless negligent business decisions and substantively unreasonable transactions that have been upheld under the business judgment rule. That is the price to be paid for deference.[67]

Of course, such deference is subject to abuse. If directors are confident that their decisions are subject to review only under the business judgment rule, it could be expected to affect their behavior. They may decide, consciously or otherwise, to shirk their responsibilities by behaving negligently. Although shirking would have to avoid gross negligence in order to escape liability, this provides little comfort to shareholders. Worse yet, directors may find ways to divert corporate assets to their personal benefit (again, consciously or otherwise). Especially in large public corporations, directors would need to redirect only a small, perhaps even insignificant, amount of assets from each shareholder to themselves in

---

64. Going to trial to determine the fairness of a transaction necessarily consumes significantly greater resources than dismissing a case because of the business judgment rule:

> As our Supreme Court has recognized, a determination that entire fairness is the appropriate standard of review 'is often of critical importance.' That conclusion normally will preclude dismissal of a complaint on a . . . motion to dismiss. . . . [T]he requirement of an entire fairness review may also preclude the entry of a final judgment even after discovery on a motion for summary judgment . . . .

Orman v. Cullman, 794 A.2d 5, 20 n.36 (Del. Ch. 2002) (citation omitted). Of course, the courts recognize that judicial economy cannot be the ultimate value in these matters. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981) ("[I]f we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits.").

65. *See supra* notes 30–31 and accompanying text.

66. *See supra* notes 20–25 and accompanying text.

67. "Establishing the proper mix of deference and accountability thus emerges as the central problem in applying the business judgment rule to particular situations." Bainbridge, *Abstention Doctrine*, *supra* note 1, at 109.

Washington University Open Scholarship

order to amass huge fortunes.[68] The outer limit for substantive overreaching—irrationality or waste—is virtually unworthy of mention.[69] Thus, the deferential nature of the business judgment rule easily could lead to an increase in negligent and substantively unreasonable business decisions. If the business judgment rule were employed too often, it would leave shareholders under-protected. While not all directors would succumb to the temptation, it would be inappropriate to assume that directors are any less frail than others.[70] Thus, prudence dictates that the business judgment rule also ought not to be overextended.

The obvious conclusion is that an all-or-nothing approach, employing either the entire fairness test or the business judgment rule, is inadequate to deal with all situations. The development of one or more intermediate standards of review was inevitable.

II. STRUCTURAL BIAS IN THE COURTS

Because the business judgment rule and the entire fairness test occupy the extreme ends of the spectrum in terms of judicial review, there are situations in which neither standard can be considered appropriate. Cases involving structural bias are the leading examples. When directors have a conflict of interest that does not rise to the level of self-dealing, the deference of the business judgment rule seems as inadequate as the rigor of the entire fairness test seems excessive.

The issue of structural bias has not escaped the notice of the courts. Their response, however, has not been entirely consistent. Some courts have been more accepting than others.[71] Delaware courts have vacillated on the issue. On the one hand, they clearly have expressed hesitancy when addressing the issue of structural bias explicitly. On the other hand, the development of intermediate standards of review for breach of fiduciary

---

68. *See supra* note 42 (discussing agency theory); *see also* Bainbridge, *Abstention Doctrine*, *supra* note 1, at 107–09 (discussing trade-off between authority and accountability).

69. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000) (upholding severance package worth over $140 million after an unsuccessful fifteen months as president, albeit as "a close case").

70. *See supra* notes 44, 54–55 and accompanying text.

71. *Compare* Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983) ("We believe that the potential for structural bias on the part of a litigation committee appointed by directors who are parties to derivative actions is sufficiently great and sufficiently difficult of precise proof in an individual case to require the adoption of a prophylactic rule."), *with* Auerbach v. Bennett, 393 N.E.2d 994, 1000–03 (N.Y. 1979) (applying business judgment rule to decisions of disinterested and independent special litigation committee). *See also* Houle v. Lowe, 556 N.E.2d 51, 54–59 (Mass. 1990) (discussing different courts' approaches to derivative litigation in light of structural bias).

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

duty has been largely a response to concerns about structural bias, although not explicitly so.

This Part will explore the courts' response to structural bias. It will begin with a discussion of the cases in which the courts have resisted the concept of structural bias and then turn to cases in which they have embraced it. This review will lay the groundwork for the subsequent discussion of the true nature of structural bias and why the courts' response has been inadequate.

A. *Judicial Skepticism*

Clearly, the courts are not overly concerned with the threat of structural bias. This is obvious from the most common method of dealing with conflicts of interest. Rather than rely heavily on the entire fairness test, courts seek to eliminate the conflict altogether. One way is to have the interested directors recuse themselves from the decision-making process and to have the matter decided by disinterested directors; another way is to have the board's decision conditioned upon the approval of disinterested shareholders. In theory, at least, there would be an unconflicted decision maker, obviating the need for judicial scrutiny and justifying deference.[72] This logic is the basis for various state statutes that permit interested transactions that are approved by fully-informed, disinterested directors or shareholders.[73] Relying on these statutes, directors generally direct decisions involving conflicts of interest to disinterested directors or shareholders, and courts generally review those decisions under the business judgment rule.[74]

---

72. *See* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) ("The key to upholding an interested transaction is the approval of some neutral decision-making body. . . . [A] transaction will be sheltered from shareholder challenge if approved by either a committee of independent directors, the shareholders, or the courts.").

73. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2001); MODEL BUS. CORP. ACT § 8.61 (2002).

74. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993) ("[A]pproval of an interested transaction by either a fully-informed disinterested board of directors, or the disinterested shareholders, provides business judgment protection.") (citations omitted); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors . . . or disinterested stockholders . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."). *But see* Cooke v. Oolie, No. CIV. A. 11134, 1997 WL 367034, at *9 (Del. Ch. June 23, 1997) ("[E]ven if a board's action falls within the safe harbor of section 144, the board is not entitled to receive the protection of the business judgment rule. Compliance . . . merely shifts the burden to the plaintiffs to demonstrate that the transaction was unfair.") (unpublished opinion). *Cf. infra* notes 412–17 and accompanying text.

Washington University Open Scholarship

If structural bias were a serious concern, disinterested director approval would not be sufficient to invoke the business judgment rule. Shareholder approval might be a different story,[75] but the courts would not be so trusting of directors sitting in judgment over each other or management. Disinterested directors may not have a financial interest in the transaction in question, but they may nevertheless be conflicted with respect to the decision itself, if only because of its effect on a colleague. The concept of structural bias suggests that too much deference is inappropriate because of such conflict.

The courts' hesitancy with respect to structural bias is not limited to such general considerations. The Delaware Supreme Court first addressed the issue of structural bias explicitly in the case of *Aronson v. Lewis*.[76] The case involved a derivative action and the issue was how a plaintiff could establish demand futility.[77] The court announced a two-part test:

> [I]n determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a *reasonable doubt* is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[78]

In the course of the discussion, the court had the occasion to address the issue of structural bias briefly in a footnote:

> Critics will charge that we are ignoring the structural bias common to corporate boards throughout America, as well as the other unseen socialization processes cutting against independent discussion and decisionmaking in the boardroom. The difficulty with structural bias in a demand futile case is simply one of establishing it in the complaint . . . . We are satisfied that discretionary review by the Court of Chancery of complaints alleging specific facts pointing to

---

75. *But see infra* notes 133–35 and accompanying text.

76. 473 A.2d 805 (Del. 1984).

77. A derivative action is "a suit asserted by a shareholder on the corporation's behalf against a third party (usu[ally] a corporate officer) because of the corporation's failure to take some action against the third party." BLACK'S LAW DICTIONARY 475 (8th ed. 2004). Before shareholders can initiate a derivative action, they must make a demand that the board of directors take such action. However, demand will be excused if making such demand would be futile because of directorial interest. DEL. CH. CT. R. 23.1. *See generally infra* notes 348–69 and accompanying text.

78. *Aronson*, 473 A.2d at 814 (emphasis added).

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

> bias on a particular board will be sufficient for determining demand futility.[79]

By demanding that the plaintiff establish a strong case of bias, the court clearly rejected the notion that structural bias is an inherent aspect of director relations.

In its most recent discussion of structural bias, the Delaware Supreme Court reaffirmed and elaborated upon the *Aronson* approach. In *Beam v. Stewart*,[80] shareholders of Martha Stewart Living Omnimedia, Inc. brought a derivative action against the corporation as well as its founder, officers and directors alleging, among other things, breaches of fiduciary duty by Martha Stewart herself. The issue before the court was whether demand was futile in light of the directors' personal relationships with her and her control over the company.[81] The court concluded that demand was not futile because a majority of the directors were disinterested and independent.[82]

In the course of its opinion, the *Stewart* court considered the concept of structural bias under the rubric of "personal friendship."[83] The court acknowledged that friendships could disrupt the independence of an otherwise disinterested director.[84] However, it was convinced that this would be a very rare situation: "'Not all friendships, or even most of them, rise to this level . . . .'"[85] On this point the court was clear: "Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."[86] Instead, the plaintiff would be required to establish that the relationship in question was "of a bias-producing nature":[87]

---

79. *Id.* at 815 n.8.

80. 845 A.2d 1040 (Del. 2004).

81. "Stewart was, at all relevant times, [the company]'s chairman and chief executive. She controls over 94% of the shareholder vote." *Id.* at 1044 n.3.

82. *Id.* at 1057.

83. *See id.* at 1050–52. Friendship is only one possible understanding of structural bias. *See infra* Part II.B.

84. *See Stewart*, 845 A.2d at 1050 ("A variety of motivations, including friendship, may influence the demand futility inquiry."); *id.* ("'[S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand.'") (quoting Beam v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003); *id.* at 1052 ("[P]ersonal friendship is [not] always irrelevant to the independence calculus.").

85. *Id.* at 1050 (citation omitted).

86. *Id.*

87. *Id.*; *see also id.* at 1051 ("The difficulty with structural bias in a demand futile case is simply one of establishing it in the complaint. . . . We are satisfied that discretionary review by the Court of Chancery of complaints alleging specific facts pointing to bias on a particular board will be sufficient for determining demand futility.") (quoting Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984)).

Washington University Open Scholarship

> The Court of Chancery . . . must review the complaint on a case-by-case basis to determine whether it states with particularity facts indicating that a relationship . . . is so close that the director's independence may *reasonably* be doubted. This doubt might arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis á vis an interested director. . . . Mere allegations that they move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence for demand excusal purposes.[88]

The facts of the case demonstrate that the quantum of proof required by the court is quite high:

> Allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as "friends," even when coupled with Stewart's 94% voting power, are insufficient, without more, to rebut the presumption of independence. . . . Whether they arise before board membership or later as a result of collegial relationships among the board of directors, such affinities—standing alone—will not render presuit demand futile.[89]

The burden is especially onerous given that the plaintiff is required to make its case on the pleadings, with particularized allegations, and without the benefit of discovery.[90]

The underlying concern is not wholly unreasonable: if structural bias were accepted as a conflict of interest, it could alter radically the balance between authority and accountability.[91] Because of the nature of relationships among directors,[92] many issues that are deemed to involve

88. *Stewart*, 845 A.2d at 1051–52.

89. *Id.* at 1051.

90. *See infra* notes 350–51, 359–69 and accompanying text.

91. *See, e.g.*, Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503 (1989).

> [T]he structural bias argument has no logical terminus. . . . If familiarity breeds acquiescence in litigation matters, will it not do so in other contexts as well? If so, does this not suggest a wholesale abandonment of the business judgment rule in favor of judicial review of every board approval of a management proposal that turns out badly?

Id. at 534–35 (footnote omitted).

92. *See infra* notes 155–56 and accompanying text.

the duty of care might be considered to involve the duty of loyalty. If so, the entire fairness test would swamp the business judgment rule. However, recognition of structural bias as a conflict of interest need not lead to the conclusion that there is a breach of the duty of loyalty requiring the invocation of the entire fairness test.[93] There are other possibilities.

To be sure, the Delaware Supreme Court has not rejected the concept of structural bias outright. However, the cases discussed thus far do not provide a ringing endorsement. By requiring specific proof, the court undermined the concept of structural bias, which suggests that bias is inherent in such relationships. It would seem that the Delaware courts are not particularly sympathetic to claims of structural bias. However, the foregoing discussion does not paint a complete picture. There are many situations in which they do endorse the concept of structural bias more fully, although not necessarily under that label.

B. Endorsement Via Intermediate Standards of Review

Despite the reservations by the Delaware Supreme Court in cases such as *Aronson* and *Stewart*, the concept of structural bias has achieved considerable judicial acceptance in a number of circumstances. In fact, this section will demonstrate that structural bias is the primary reason for the development of various intermediate standards of review.

"[T]he emergence of these intermediate standards of review has been one of the major recent developments in corporate law."[94] It is not a surprising development, given the extreme divergence between the business judgment rule and the entire fairness test. However, it was less predictable that intermediate standards would multiply rather than coalesce. When confronted with circumstances that required it, the courts developed intermediate standards of review for the specific situations before them. The individual intermediate standards were surely better than either basic alternative but were not particularly apt. Had the courts been willing to recognize that the various standards address the same general concern—structural bias—they might have been able to develop a comprehensive theory of review.

93. *See infra* note 153 and accompanying text.
94. Eisenberg, *supra* note 18, at 467.

Washington University Open Scholarship

1. *Hostile Takeovers*

One obvious endorsement of the concept of structural bias can be found in *Unocal Corp. v. Mesa Petroleum Co.*[95] In that case, Mesa Petroleum Company made a two-tier, front-loaded tender offer for the shares of Unocal:[96] it offered $54 per share in cash to acquire a majority of the shares, after which point it would squeeze out the remaining shareholders for subordinated securities with a face value, but not a market value, of $54.[97] "[S]uch offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction."[98] The Unocal board responded in kind. Its defense was a selective self-tender in which the company would exchange 49% of its shares for senior debt securities worth $72 per share, but the offer was not open to Mesa Petroleum.[99] This effectively would cause Mesa Petroleum to pay the higher amount on the back end of its transaction in order to proceed. "[T]he board stated that its objective was either to defeat the inadequate Mesa offer or, should the offer still succeed, provide the [remaining] stockholders, who would otherwise be forced to accept 'junk bonds', with [additional consideration]."[100] Mesa challenged the discriminatory nature of the defensive measure, but Unocal prevailed.

The Delaware Supreme Court noted that directors must be free to respond to hostile takeover offers in the interests of shareholders.[101] However, the court also recognized that, in circumstances involving the threat of a hostile takeover, there is an "omnipresent specter that a board may be acting primarily in its own interests [i.e., entrenchment], rather than those of the corporation and its shareholders [i.e., maximizing shareholder wealth]."[102] This "omnipresent specter" is nothing more than an articulation of structural bias. Although the court did not see the case as

95. 493 A.2d 946 (Del. 1985).

96. "[A] two-tier, front-loaded tender offer is a tender offer for a majority of a company's shares with the explicit or implicit promise of a subsequent merger in which the minority shareholders will be eliminated for inferior consideration." Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 386 n.27 (2002).

97. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985).

98. *Id.* at 956.

99. *See id.* at 950.

100. *Id.* at 956.

101. "When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment." *Id.* at 954.

102. *Id.*

involving self-dealing, it understood that directors were conflicted. This is the essential claim of structural bias.

In response, the court recognized "an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[103] The threshold inquiry established by the court was a new intermediate standard of review in the form of a bipartite test. First, "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . . ."[104] Second, the defensive measures "must be reasonable in relation to the threat posed."[105] This seemed to be a reasonable attempt to balance the competing concerns with an intermediate standard of review.

Unfortunately, there was not much depth to the enhanced scrutiny. As the Delaware Supreme Court noted, directors can "satisfy [the first prong] 'by showing good faith and reasonable investigation . . . .'"[106] With respect to the second prong, the court would subsequently clarify that "'courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.'"[107] These elaborations make the enhanced scrutiny standard sound strikingly similar to the business judgment rule.[108]

In fact, as the court would later explain, there is "a direct correlation between findings of proportionality or disproportionality and the judicial determination of whether a defensive response was draconian because it was either coercive or preclusive . . . ."[109] In other words, a defensive response is likely to be considered unreasonable only if it is either coercive or preclusive.[110] With such limitations on judicial review, the enhanced scrutiny standard cannot serve the primary function of an intermediate standard of review: to bridge the gap between the business judgment rule and the entire fairness test.[111]

---

103. *Id.*

104. *Id.* at 955.

105. *Id.*

106. *Id.* (citing Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)).

107. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995) (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45–46 (Del. 1994)).

108. *See* Velasco, *supra* note 96, at 385–90, 416–22 (2002); *id.* at 390 n.58 ("Directors thus are afforded substantially the benefits of the business judgment rule before it can be determined that they are entitled to its protection . . . .").

109. *Unitrin*, 651 A.2d at 1387.

110. *See* Velasco, *supra* note 96, at 419.

111. The "enhanced scrutiny" that is applied to takeover defenses extends beyond *Unocal*. It arguably consists of three different standards of review, the applicability of which depends upon the particular circumstances. *Unocal* set forth the basic aspect of "enhanced scrutiny." The second aspect is derived from *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

Washington University Open Scholarship

There, the court recognized that there may come a point in a takeover battle when it is clear that the company will be sold. *See id.* at 182 (discussing inevitability of "the break-up of the company"); *see also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1288 (Del. 1989) (clarifying that "sale of corporate control" is a triggering factor); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 48 (Del. 1994) (listing both "change in corporate control" and "break-up of the corporate entity"). At that point, "[t]he duty of the board . . . change[s] from the preservation of [the company] as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit." *Revlon*, 506 A.2d at 182. If *Revlon* duties apply, directors must "seek the best value reasonably available to the stockholders." *QVC Network*, 637 A.2d at 48. Conduct that favors a white knight over a hostile bidder is suspect. *Revlon*, 506 A.2d at 184.

The *Revlon* decision can be seen either as an entirely new test or merely as a specific application of *Unocal*. *Revlon* generally does not allow directors to employ defensive measures to resist a hostile bidder: directors' responsibility is narrowly prescribed and their discretion is limited. *See Revlon*, 506 A.2d at 182 ("The whole question of defensive measures bec[o]me[s] moot. The directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."). This is in sharp contrast to *Unocal*. On the other hand, it can be argued that *Revlon* flows logically from *Unocal*. Once a sale of control is inevitable, perhaps the only course of conduct that could be considered "reasonable" under *Unocal* would be to seek the best value reasonably available to stockholders. *Cf.* Allen et al., *supra* note 3, at 895 ("Except for requiring the court to evaluate the reasonableness of the directors' action against the singular objective of current value maximization, the *Revlon* standard differs little from the *Unocal* standard in practical application."). This seems to have been the *Revlon* court's view. *Revlon*, 506 A.2d at 182 (characterizing *Revlon* duties as "significantly altered . . . responsibilities under the *Unocal* standards").

A third aspect of "enhanced scrutiny" applies to actions taken "for the primary purpose of thwarting the exercise of a shareholder vote." Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 660 (Del. Ch. 1988). In *Blasius*, the Delaware Court of Chancery ruled that such action by a board of directors would be upheld "only if it was supported by a compelling justification." Chesapeake Corp. v. Shore, 771 A.2d 293, 319 (Del. Ch. 2000) (citing *Blasius*, 564 A.2d at 660–63). This holding was later endorsed by the Delaware Supreme Court. *See* Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992).

Although the *Blasius* court rejected a per se rule against such actions, see *Blasius*, 564 A.2d at 660–61, the standard is nevertheless "quite onerous." Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996). The reason given for the demanding standard was "the central importance of the franchise to the scheme of corporate governance." *Blasius*, 564 A.2d at 659. According to the *Blasius* court, other forms of takeover defense generally "involve the exercise of the corporation's power over its property, or with respect to its rights or obligations," *id.* at 660—judgments which are appropriately made by the board of directors. Decisions as to the composition of the board of directors, on the other hand, are the prerogative of the shareholders. *See id.* Thus, director interference in shareholder democracy is arguably illegitimate.

As with *Revlon*, the *Blasius* test can be seen either as an entirely new test or merely as an application of *Unocal*. Clearly, a "compelling justification" standard is far more demanding than a "reasonableness" standard. In fact, while the *Unocal* standard has been characterized as providing little more protection than the business judgment rule, the *Blasius* standard probably exceeds the rigor of the entire fairness test. On the other hand, it can be argued that *Blasius* also flows logically from *Unocal* because intentional interference with shareholder voting rights is unreasonable under most circumstances. *See* Allen et al., *supra* note 3, at 884–90 ("[T]he post-*Blasius* experience has shown that the *Unocal/Unitrin* analytical framework is fully adequate to capture the voting franchise concerns that animated *Blasius*, so long as the court applies *Unocal* 'with a gimlet eye out for inequitably motivated electoral manipulations or for subjectively well-intentioned board action that has preclusive or coercive effects.'") (quoting *Chesapeake*, 771 A.2d at 323). In fact, the Delaware Supreme Court's interpretation of *Blasius* is not far off. *See Stroud*, 606 A.2d at 92 n.3 ("A board's unilateral decision to adopt a defensive measure touching 'upon issues of control' that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a 'compelling

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

2. Derivative Litigation

A second obvious endorsement of the concept of structural bias can be found in *Zapata Corp. v. Maldonado*.[112] That case involved a derivative action in which demand had been excused as futile because all of the directors were defendants in the case. However, the board subsequently established a "Special Investigation Committee," composed of two newly-appointed directors, to consider whether the case should be dismissed. The committee concluded that it should, and the Delaware Supreme Court had to decide whether the motion to dismiss should be granted. The court held that "an independent committee possesses the corporate power to seek the termination of a derivative suit."[113] However, the court also believed that "there [was] sufficient risk in the realities of [the] situation . . . to justify caution."[114] The court described those "realities" as follows:

> [W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.[115]

The "realities" of *Zapata* are not very different from the "omnipresent specter" of *Unocal*; it is simply another articulation of structural bias. It is an empathy and bias on the part of all directors rooted in their relationship as colleagues. Despite the lack of self-dealing—because the newly-

---

justification.'"). The court's most recent discussion of *Blasius*, however, is more nuanced. *Compare* MM Cos., Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1129 (Del. 2003) (noting "the substantial degree of congruence between the rationale that led to the *Blasius* 'compelling justification' enhanced standard of judicial review and the logical extension of that rationale *within* the context of the *Unocal* enhanced standard of judicial review"), *with id.* at 1130 (noting that *Blasius* standard can be applied "either independently, in the absence of a hostile contest for control, or within the *Unocal* standard of review when the board's action is taken as a defensive measure").

Thus, "enhanced scrutiny" could be characterized as a single test, based on *Unocal*. On the other hand, it seems as a practical matter to consist of three separate tests: one of general applicability in situations involving takeover defenses, and two additional tests for specific circumstances. Either way, "enhanced scrutiny" demonstrates that the courts realize that management cannot necessarily be trusted to act in the shareholders' interests even in the absence of self-dealing.

112. 430 A.2d 779 (Del. 1981).

113. *Id.* at 785.

114. *Id.* at 787.

115. *Id.*

Washington University Open Scholarship

appointed directors were not defendants—the court was unwilling to say that the disinterested directors were truly unconflicted. Thus, the court felt that the directors' decision required closer scrutiny.

The response of the Delaware Supreme Court was to reserve the right to reject the committee's decision altogether if the circumstances warrant.[116] The court set forth a two-part test for reviewing the decision of an independent committee of directors to dismiss a derivative lawsuit. "First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. . . . The corporation should have the burden of pro[of]."[117] Second, "[t]he Court should determine, applying its own independent business judgment, whether the motion should be granted."[118]

This second step is an odd one. According to the Delaware Supreme Court, "[t]he second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit . . . ."[119] This is a perfectly reasonable concern. However, the method adopted by the court is theoretically and doctrinally suspect. Recognition of courts' incompetence to make business decisions is one of the foundations of the business judgment rule.[120] Yet the Delaware Supreme Court—perhaps the ultimate judicial oracle on corporate law matters—decided to give lower courts the discretion to apply their own business judgment over and above that of the directors who already would have been determined to be independent.[121] This decision has been widely criticized,[122] and many courts have refused to follow its lead.[123]

---

116. *Id.* at 788. The court seemed to understand the implications of its solution but felt that it was justified by the circumstances: "We recognize the danger of judicial overreaching but the alternatives seem to us to be outweighed by the fresh view of a judicial outsider. Moreover, if we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits." *Id.*

117. *Id.*

118. *Id.* at 789.

119. *Id.*

120. *See supra* notes 30–31 and accompanying text.

121. Although the courts may consider the directors to be independent under their standards, the directors may not be truly independent. *See infra* Part III.

122. *See, e.g.*, Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva* Zapata*?*, 37 BUS. LAW. 27, 62–63 (1981); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 937–41 (1982); Charles Mark Holt, Alford v. Shaw*: North Carolina Adopts a Prophylactic Rule to Prevent Termination of Shareholders' Derivative Suits Through Special Litigation Committees*, 64 N.C. L. REV. 1228, 1245–47 (1986); Kriston D. Qualls, Note, Zapata Corp. v. Maldonado*: Delaware's Judicial Business Judgment Rule—A Ship Without a Rudder?*, 19 CAL. W. L. REV. 189, 209–10 (1983).

123. *See, e.g.*, Hirsch v. Jones Intercable, Inc., 984 P.2d 629, 637 (Colo. 1999); Miller v. Register

In addition, one must struggle to find a principled way to limit the rationale for the second step of the *Zapata* test to derivative litigation. If the possibility of "subconscious abuse" stems from the fact that "directors are passing judgment on fellow directors,"[124] then the principle should apply much more broadly. If independent directors cannot be trusted with respect to derivative litigation, they probably should not be trusted with respect to other conflict situations, either.[125] There is no good reason to have a special rule for derivative litigation: whenever directors sit in judgment over other directors, "the realities of [the] situation . . . justify caution."[126] This is the essential claim of structural bias.

Zapata is thus quite similar to *Unocal*. In each case, directors needed leeway to act in the interests of shareholders but could not be trusted completely to do so. The root of the problem is structural bias, and it demands a comprehensive solution. There is no good reason to have one special rule for hostile takeovers and another special rule for derivative litigation.

3. *Disinterested Approval*

A somewhat more tenuous endorsement of the concept of structural bias can be found in a third category of intermediate standard of review. That standard is a shift in the burden of proof on the issue of fairness, whereby the plaintiff has the burden of proving that the decision or transaction in question is unfair.[127] In Delaware, this intermediate standard

---

& Tribune Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983); Houle v. Low, 556 N.E.2d 51, 59 (Mass. 1990); Auerbach v. Bennett, 393 N.E.2d 994, 1002–03 (N.Y. 1979); Alford v. Shaw, 358 S.E.2d 323, 326 (N.C. 1987); Lewis v. Boyd, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992); *see also* MODEL BUS. CORP. ACT § 7.44 (2002) (adopting business judgment rule approach).

"The fact that there have been no reported major trials to apply the *Zapata* approach raises questions as to whether courts or litigants ever will be serious about obtaining an independent judicial evaluation of the corporation's interest." GEVURTZ, *supra* note 14, at 434.

124. *Zapata*, 430 A.2d at 787.

125. It could be argued that all corporate decisions suffer under this logic because outside directors are always sitting in judgment on the inside directors. *See supra* note 91. The force of this argument is strengthened by the fact that most challenges to director misbehavior must be channeled through a derivative action.

However, the argument is a non-sequitur. All human judgment is imperfect, but in most circumstances the directors' judgments are the best available. In situations where both inside and outside directors are honestly pursuing the interests of shareholders, structural bias is not a problem and directors' judgments can be trusted. In conflict situations, on the other hand, directors may perceive themselves as pitted against shareholders and thus cannot be trusted. A special rule for conflict situations does not undermine the application of the business judgment rule generally.

126. *Zapata*, 430 A.2d at 787.

127. A mere shift in the burden of proof may not seem like an intermediate standard of review because the underlying issue of fairness does not change. However, there is a significant practical

Washington University Open Scholarship

applies when the interested party is a controlling shareholder rather than merely one or more directors.[128] In California, however, the principle applies to interested directors as well.[129] Although not clearly expressed in such terms, the underlying concern must be that even independent directors cannot be trusted to act in the interest of shareholders. Again, that is the essential claim of structural bias.

The test itself—that the plaintiff bears the burden of proving the unfairness of the transaction or decision—is not a bad one. It does a better job in bridging the gap between the business judgment rule and the entire fairness test than any of the previous standards. However, as a general test for structural bias, it probably tilts too greatly toward accountability over directorial authority. After all, fairness is supposed to be a demanding standard.[130] If so, then shifting the burden of proof, while significant, would not go far enough in relaxing the standard.[131]

Admittedly, it is difficult to argue that the court's overall handling of cases involving disinterested director or shareholder approval amounts to an endorsement of the concept of structural bias. After all, the general rule

---

difference, from the directors' point of view, between having to prove that a transaction is entirely fair on the one hand and having to avoid a characterization of unfairness on the other. If a standard of review is a "test a court [applies] when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief," Eisenberg, *supra* note 18, at 437, and "defines the freedom of action (or, if you will, deference in the form of freedom from intrusion) that will be accorded to the persons who are subject to its reach," Allen et al., *supra* note 3, at 867, then a shift in the burden of proof on the issue of fairness amounts to a new standard of review.

128. *See* Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110, 1117 (Del. 1994) ("[A]n approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff."); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) ("[W]here corporate action has been approved by an informed vote of a majority of the minority shareholders, we conclude that the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority."); *see also In re* Wheelabrator Techs., Inc. S'holders. Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995).

129. *See, e.g.*, CAL. CORP. CODE § 310(a)(2) (West 1990) (requiring, in addition to disinterested director approval, that a transaction be "just and reasonable"); Sammis v. Stafford, 56 Cal. Rptr. 2d 589, 594 (Cal. Ct. App. 1996) ("Where a *dis*interested majority approves the transactions and there was full disclosure, section 310(a)(2) applies, and the burden of proof is on the person challenging the transaction."); *see also* Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74–75 (Cal. Dist. Ct. App. 1952). The *Remillard* case is the origin of the principle in California and was subsequently codified. *See* CAL. CORP. CODE § 310, legislative committee cmt. (1975) ("There is an additional requirement that the transaction be just and reasonable as to the corporation at the time it is approved, which is intended to codify a judicial decision indicating that the courts in any event will review the transaction for fairness.").

130. *But see infra* note 137 and accompanying text.

131. Another drawback is that, even with a shift in the burden of proof, a fairness standard would result in a dramatic increase in litigation expenses. *See supra* note 64; *cf. infra* notes 298–309 and accompanying text.

is that the business judgment rule applies.[132] Such deference is inconsistent with a concern about structural bias.

Moreover, many cases of burden shifting involve disinterested *shareholder* approval.[133] Shareholder action has little to do with structural bias. In such cases, the shift is premised on "the potential for process manipulation by the controlling stockholder, and the concern that the controlling stockholder's continued presence might influence even a fully informed shareholder vote."[134] Nevertheless, the dynamic in such cases is not entirely dissimilar to structural bias. An uncontrolled conflict of interest that does not rise to the level of self-dealing is a common theme. The minority shareholders may not be conflicted, but they cannot effectively police the controlling shareholder either. Because it is difficult to have confidence in shareholder approval, the invocation of the business judgment rule is unwarranted.[135] Thus, although structural bias may not be involved, the situation is similar enough that a common solution should be feasible. In short, the shifting of the burden of proof on the issue of fairness provides some additional support for the notion that courts do, in fact, appreciate the concerns underlying structural bias.

III. A CLOSER LOOK AT STRUCTURAL BIAS

Courts recognize the importance of protecting beneficiaries from the conflicts of interest of their fiduciaries. Thus, they tend to describe the standard of conduct for the duty of loyalty in the strongest of terms.[136] The effective standard of review, however, is not nearly so strong.[137] Although

132. *See supra* notes 72–75 and accompanying text.

133. *See supra* note 128 and accompanying text.

134. *In re* Wheelabrator Techs. S'holders. Litig., 663 A.2d. 1194, 1205 (Del. Ch. 1995); *see also* Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990).

135. There must be some independent approval of an interested transaction. *See* Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) ("The key to upholding an interested transaction is the approval of some neutral decision-making body. . . . [A] transaction will be sheltered from shareholder challenge if approved by either a committee of independent directors, the shareholders, or the courts.").

136. *See supra* notes 51–53 and accompanying text.

137. It is not clear that the entire fairness test is quite as strict as judicial statements suggest. In the first place, the courts have required more than merely a conflict of interest to invoke the test. There must be some evidence of disloyalty, see Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993) ("[S]elf-interest, alone, is not a disqualifying factor even for a director. To disqualify a director, for [business judgment] rule rebuttal purposes, there must be evidence of disloyalty."), such as self-dealing. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("[T]he intrinsic fairness standard . . . will be applied only when the fiduciary duty is accompanied by self-dealing . . . ."). In fact, the conflict of interest must be "material," and not merely "colorable." *See Cede & Co.*, 634 A.2d at 364 ("A trial court must have flexibility in determining whether an officer's or director's interest in a challenged board-approved transaction is sufficiently material to find the director to have breached

Washington University Open Scholarship

it may make sense to set the standard of review lower than the standard of conduct,[138] the status quo leaves shareholders under-protected.

Under current law, enforcement of the duty of loyalty essentially amounts to a prohibition against self-dealing.[139] "[A] classic self-dealing transaction [is one] where a [fiduciary] stand[s] on both sides of a transaction,"[140] or "when the [fiduciary] . . . causes the [company] to act in such a way that the [fiduciary] receives something from the [company] to the exclusion of, and detriment to, the . . . stockholders of the [company]."[141] Self-dealing is an inadequate concept to address conflicts of interest for at least two reasons. First, it is not always easy for a plaintiff to demonstrate that self-dealing is involved. In many situations, the directors can argue plausibly that they are acting in the interests of shareholders even as they pursue their own agenda.[142] Second, directors themselves may be unaware that they are not acting in the interests of shareholders. Bias may cloud their judgment.[143]

---

his duty of loyalty and to have infected the board's decision."). Moreover, the entire fairness test does not require that a director's conduct be perfect, only that it be fair. *See* Pepper v. Litton, 308 U.S. 295, 306–07 (1930) ("The essence of the test [of intrinsic fairness] is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995) ("A finding of perfection is not a *sine qua non* in an entire fairness analysis.") (citing Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983)). Finally, it is possible that director action could fail the more lenient business judgment rule and nevertheless withstand scrutiny under the entire fairness test. *Compare Cede & Co.*, 634 A.2d 345 (defendant directors grossly negligent and not entitled to protection of business judgment rule), *with Cinerama*, 663 A.2d 1156 (defendants satisfy burden of proving entire fairness on remand). There is nothing inherently illogical about such a result because a grossly negligent board could produce an entirely fair result fortuitously. Yet, there is something deeply unsettling about the possibility, and it casts doubt on the strictness of the entire fairness test. *Cf.* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993) (arguing that fairness test is inadequate standard of review for fiduciary obligations).

138. *See generally* Eisenberg, *supra* note 18.

139. It has been said that the entire fairness test "will be applied only when the fiduciary duty is accompanied by self-dealing . . . ." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). Nevertheless, enforcement of the duty of loyalty is not limited strictly to self-dealing. *See, e.g.*, *Cede & Co.*, 634 A.2d at 360 ("'The presumption [of the business judgment rule] initially attaches to a director-approved transaction within a board's conferred or apparent authority in the absence of any evidence of 'fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment.'") (quoting Grobow v. Perot, 539 A.2d 180, 187 (1988)). However, courts often use self-dealing as shorthand, and generally require that the disloyalty "rise to the level of self-dealing." *See id.* at 363.

140. *Cede & Co.*, 634 A.2d at 362.

141. *Sinclair Oil*, 280 A.2d at 720.

142. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182–84 (Del. 1986) (discussing potential benefits and detriments of lock-up options and no-shop provisions); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (rejecting simple application of business judgment rule in hostile takeover setting "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

143. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (questioning "whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

Moreover, directors face many situations that, strictly speaking, do not involve self-dealing but in which they nevertheless may be conflicted. This is the case whenever directors stand to gain some benefit that is meaningful to them but which courts currently are unwilling to recognize as compromising their impartiality, perhaps because the benefit to directors is too intangible, indirect, or speculative. However, sometimes the benefit is quite concrete, such as the preservation of their positions; other times, the benefit is more indirect, such as the protection of a colleague, or speculative, such as the increase of benefits or reduction of accountability generally. In some such situations—e.g., hostile takeovers and derivative litigation—the courts already have recognized that neither the business judgment rule nor the entire fairness test is appropriate,[144] but in other situations—e.g., executive compensation decisions—they have not.

Although structural bias is the root of the problem, the topic rarely has been considered carefully. The failure to appreciate the true nature of structural bias has led to an inadequate judicial response to breach of fiduciary duty, at least at the intermediate level. This Part will consider structural bias in depth. It will propose three very different paradigms for understanding structural bias. First, structural bias can be understood as a form of implicit conspiracy: directors may pursue their group interests consciously, even in situations where there is no obvious personal benefit. Second, structural bias may be understood as the effect of relationships: directors may favor friends and colleagues over distant shareholders. Third, structural bias may be understood as a psychological phenomenon: a manifestation of ingroup bias, which may operate on an unconscious level. The claim is not that each instance of structural bias fits neatly within one of the three paradigms; rather, it is that each of these paradigms may be applicable, to a greater or lesser degree, to any situation involving structural bias.

After considering each of the paradigms in turn, this Part will turn to the issue of whether and how structural bias might be overcome. The argument is that it cannot be. A proper understanding of structural bias serves to undermine confidence in the independence of all directors when there is a conflict of interest. Because the business judgment rule presupposes and demands such confidence, structural bias forces a reconsideration of the issue of dealing with such cases. In the face of

abuse, perhaps subconscious abuse" in context of derivative litigation). This issue is considered in more detail *supra*, at Part II.B.

144. *See supra* Part II.B.

Washington University Open Scholarship

structural bias, the judicial practice of deferring to the judgment of "disinterested" directors becomes indefensible. Thus, an appropriate intermediate standard of review becomes indispensable.

A. As Implicit Conspiracy

One possible paradigm for structural bias contemplates an implicit conspiracy among directors to pursue their group interests. According to this implicit conspiracy theory, even independent directors may show favoritism for other directors because of the indirect benefits of doing so.

The central claim of this theory is that all directors are interested directors when conflicts are the issue. "Independent" directors may be disinterested in the transaction in question, but they are not disinterested in the corresponding decision. The transaction may not offer them anything to the exclusion of shareholders, but the decision to favor other directors will. At the most abstract level, directors may show favoritism for each other out of solidarity or in return for the expectation of similar treatment.[145] At the most concrete level, they may do so because it is necessary to maintain their membership on the board.[146]

The implicit conspiracy is more expansive than it may first appear. This is because directors' group interests extend beyond those of directors as such and include the group interests of management as well. It is easy to see why this would be the case with inside directors: they *are* the management. However, it is also true of outside directors because most outside directors are either executive officers of other companies, or at least former executive officers.[147] Because executive officers naturally prefer pro-management boards, they may extend to each other the courtesy of deference. Thus, the implicit conspiracy covers the interests of officers as well as directors.

In a strong form of the argument, the implicit conspiracy theory can be seen as nothing more than thinly-veiled self-dealing: directors might pursue their own immediate interests. A high-profile example would be

---

145. *See infra* notes 150–51 and accompanying text.

146. *See infra* notes 148–49 and accompanying text; *see also infra* notes 162–63 and accompanying text.

147. "Outside directors tend to be corporate officers or retirees who share the same views and values as the insiders." BAINBRIDGE, CORPORATION LAW, *supra* note 1, at 227. In large public companies these days, only a minority of directors are insiders. *See* SPENCER STUART, BOARD INDEX 6 (2003) (approximately 20%). However, the great majority of new outside directors continue to be current or retired corporate executives. *See id.* at 7. In selecting outside directors, boards strongly prefer senior executives in other companies. *See* NAT'L ASS'N OF CORP. DIRECTORS, 2003–2004 PUBLIC COMPANY GOVERNANCE SURVEY 16–17 (2003) (almost 85% of first-choice picks).

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

the entrenchment motive.[148] By resisting hostile takeovers and proxy fights, directors may be acting to preserve their positions on the board of directors. This would be self-dealing because significant benefits, both financial and other, flow from such membership.[149]

In a more moderate form of the argument, the implicit conspiracy theory can be seen as a form of enlightened self-interest. Although there may be no specific personal benefit from the decision at hand, directors might engage in favoritism because it is the type of behavior that would benefit them in other circumstances. A high-profile example would be executive compensation. By setting a liberal tone generally, directors can increase the likelihood of a better compensation package for themselves in their full-time positions.[150]

In a weak form of the argument, the implicit conspiracy theory merely posits a coalition of like-minded individuals. Directors might act together because they share the same ideals, which just happen to align conveniently with their interests. A high-profile example would be derivative litigation. Directors naturally are averse to derivative litigation, which directly affects them in their roles both as directors and as officers. Thus, it is not surprising to find that they consistently reject demands and otherwise seek dismissal of derivative actions.[151]

In short, the claim of the implicit conspiracy theory is that structural bias inherently carries a potential for self-dealing which is similar to that already recognized by the courts. Even if disinterested directors are not on both sides of the transaction, they are on both sides of the relevant issue. When directors have such conflicted interests, it is difficult to have confidence in their judgment and they cannot be afforded the deference of the business judgment rule.

---

148. *See generally supra* Part II.B.2.

149. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 25–30 (2004); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 93–96 (1985).

150. *Cf.* BEBCHUK & FRIED, *supra* note 149, at 71–72 (discussing escalation of executive compensation).

151. *See* GEVURTZ, *supra* note 14, at 412 ("Special litigation committees, almost without exception, have concluded that derivative suits which the committees looked into were not in the corporation's best interests."); *see also* BAINBRIDGE, CORPORATION LAW, *supra* note 1, at 395, 399–400.

Washington University Open Scholarship

B. As Relationship—Friendship and Collegiality

A second possible paradigm for structural bias is based on the strength of relationships and claims that directors may pursue the interests of their friends and colleagues on the board over those of distant shareholders. According to this relationship theory, disinterested directors are likely to favor interested directors over shareholders out of friendship and collegiality.

Courts have difficulty with the concept of friendship because of their narrow understanding of what constitutes a conflict of interest. Conflicts come in more forms than courts are willing to recognize, at least under the duty of loyalty. In order to raise a cognizable duty of loyalty issue and invoke the entire fairness test, shareholders generally must identify a direct or indirect financial interest that could tempt directors.[152] Money, however, is not the only value that motivates directors, for good or for ill. For example, integrity often motivates directors to forsake their own interests and fulfill their fiduciary duties to shareholders.[153] Friendship, on the other hand, may motivate directors to shirk their fiduciary duties for the sake of their colleagues.

Courts do not feel comfortable with intangible values such as friendship. Thus, they generally do not accept friendship as a ground for challenging director independence.[154] There is a very practical consideration in this: in the business world, as in any other setting, friendships are common.[155] If shareholders were allowed to raise a duty of

---

152. Although courts may not require explicitly that the interest be financial in nature, the entire discourse clearly reflects an assumption to that effect. *See supra* note 139; *see also* DEL. CODE ANN. tit. 8, § 144(a) (2001) (discussing director interest in terms of direct and indirect "financial interest"); 2 MODEL BUS. CORP. ACT § 8.60, at 8-377 to -379 (2002) (defining "conflicting interest" primarily in terms of direct or indirect "financial interest"); 1 RODMAN WARD, JR. ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2.1.1, at GCL-IV-20 (4th ed., 2004-1 Supp.) [hereinafter FOLK] ("Most basically, the duty of loyalty proscribes a fiduciary from any means of misappropriation of assets entrusted to his management and supervision.").

Familial relations also generally are considered to be a sufficiently disqualifying interest. *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) ("a majority of the board has a material financial or familial interest"). However, they are usually linked with financial interest and are essentially seen as a species of an indirect financial interest. Courts are willing to entertain the possibility that there are non-financial bonds that may impact director independence, see *infra* note 154 and accompanying text, but this recognition is more theoretical than real, see *infra* notes 155–56 and accompanying text.

153. *Cf.* Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*, 26 ARIZ. ST. L.J. 91, 127 (1994) (similar); Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite* Homo Economicus *to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003) (discussing director motivations other than money).

154. *See supra* notes 80–89 and accompanying text.

155. "Business dealings seldom take place between complete strangers and it would be a strained and artificial rule which required a director to be unacquainted or uninvolved with fellow directors in

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

loyalty issue and invoke the entire fairness test merely by pointing to conflicts arising from friendship, the presumption of the business judgment rule would be watered down severely. This is not something courts are willing to do.[156]

However, the influence of friendship should not be underestimated. To pretend that financial interests are inherently stronger than the bonds of friendship is both substantively indefensible and morally insulting. Surely there are many things that one would not do for money that one might nevertheless do for a friend.[157] Moreover, friends are often willing to give each other the benefit of the doubt even when it might seem objectively unreasonable to do so.[158] Thus, a director is likely to be conflicted when a friend's interests are at stake.

According to the Delaware Supreme Court, friendship should be considered material to a director's independence only if, "because of the nature of [the] relationship . . . , the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director."[159] The problem with this argument is that it assumes that favoritism entails a significant degree of risk. When their actions are to be reviewed under the business judgment rule, directors know that they do not face any real risk from judicial scrutiny.[160] Moreover, the relevant reputation for directors is the one among their peers, who face the same

---

order to be regarded as independent." *In re* Oracle Securities Litigation, 852 F. Supp. 1437, 1442 (N.D. Cal. 1994).

156. *See* Beam v. Stewart, 845 A.2d 1040, 1052 (Del. 2004) ("[F]riendship must be accompanied by substantially more in the nature of serious allegations that would lead to a reasonable doubt as to a director's independence."); *see also* Orman v. Cullman, 794 A.2d 5, 21 n.36 (Del. Ch. 2002) ("Recognizing the practical implications of the automatic requirement of an entire fairness review has led our Supreme Court to limit such automatic requirement to [a] narrow class of cases . . . ").

157. *Cf.* Cass R. Sunstein, *Incommensurability and Valuation in Law*, 92 MICH. L. REV. 779, 785–86 (1994) (discussing incommensurability of friendship and money). *But see id.* at 812–13.

158. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance With Law*, 2002 COLUM. BUS. L. REV. 71, 86 ("[D]iscovering a compliance risk is unpleasant and hence aversive, especially if the employee is also a friend. . . . [P]eople tend to interpret data in a way that avoids aversive inference, subconsciously giving the agent an excessive benefit of the doubt."); Linda Ross Meyer, *Forgiveness and Public Trust*, 27 FORDHAM URB. L.J. 1515, 1537 (2000) ("[I]n everyday life, we give many second chances and even more benefits of the doubt to friends, family members, and associates for the sake of continuing and preserving the relationships.").

159. *Stewart*, 845 A.2d at 1052, *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership & Control*, 26 J. L. & ECON. 301, 315 (1983) ("[O]utside directors will monitor the management that chooses them because outside directors have incentive to develop reputations as experts in decision control.").

160. *See supra* notes 67–70 and accompanying text. The risk seems slight indeed when the additional difficulties of initiating and maintaining a derivative action are considered. *See generally* GEVURTZ, *supra* note 14, at 395–423.

Washington University Open Scholarship

issues and are likely to be quite sympathetic.[161] In the end, directors are left to grapple with two competing moral values—duty and friendship—both of which claim the title of loyalty. Under these circumstances, it is difficult to have confidence in their judgment.

Collegiality, while perhaps not as powerful an influence as friendship, should not be underestimated, either. The culture in corporate boardrooms is one of cooperation, not adversity.[162] "Individuals who are quarrelsome, disagreeable, or rigid" are not likely to obtain or maintain membership on a board of directors.[163] In such an environment, it would not be easy to question colleagues' integrity by raising loyalty issues. Thus, even directors who are not friends may not be very critical of each other.

In short, the claim of the relationship theory is that structural bias affects directors because of their friendship and collegiality. It does not mean to suggest that directors are unable to act in the interests of shareholders; only that they are likely to be ambivalent. When directors are so conflicted, it is difficult to have confidence in their judgment, and they cannot be afforded the deference of the business judgment rule.

C. As Psychological Phenomenon—Ingroup Bias

A third possible paradigm views structural bias as a complex psychological phenomenon. According to this psychological phenomenon theory, even disinterested directors will tend to favor other directors because of psychological forces such as ingroup bias.

It is often assumed that structural bias entails conscious decisions by directors to prefer management interests to those of shareholders.[164] Viewed as such, it becomes a question of integrity. Although few would doubt that some directors might consciously disregard their duty some of

---

161. *Cf.* Lucian Arye Bebchuk, et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 771 (2002) (arguing that reputation as experts in decision control may not be most relevant factor in market for directors).

162. *See* Bebchuk et al., *supra* note 161, at 767–69 (2002); Cox & Munsinger, *supra* note 149, at 91–92.

163. *See* Cox & Munsinger, *supra* note 149, at 91.

164. *See, e.g.*, Dooley & Veasey, *supra* note 91, at 535 (1989) ("The structural bias argument asks us to believe that outside directors generally are more willing to risk reputation and future income than they are to risk the social embarrassment of calling a colleague to account."); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 405–06 (1997) ("Friendship, golf companionship, and social relationships are not factors that necessarily negate independence. . . . To make a blanket argument otherwise would create a dubious presumption that the director would sell his or her soul for friendship."); *see also* Coffee & Schwartz, *supra* note 7, at 283 (structural bias "may cause even the outside director to perceive his role . . . as that of a buffer by which to shelter and protect management . . . . ").

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

the time, a theory that implicitly questions the integrity of all directors is difficult for many to accept. In fact, however, structural bias extends much further than conscious discrimination into the realm of semi-conscious, and even unconscious, bias. It is this less-than-conscious aspect that makes structural bias so dangerous and intractable. The claim is not that disinterested directors are dishonest or self-serving; rather, it is that even disinterested directors are not—indeed, cannot be—truly impartial.[165]

Under this psychological phenomenon theory, structural bias can be understood as a manifestation of ingroup bias. Ingroup bias is "the tendency to favor the in-group over the out-group in evaluations and behavior."[166] Although the theories explaining ingroup bias may be the subject of debate,[167] evidence of the existence of ingroup bias is extensively documented in the psychological literature.[168] "Both psychological research and real world experience support the conclusion that ingroup bias is a remarkably prevalent and robust phenomenon."[169] Although this favoritism is magnified as a person's attraction to and identification with the ingroup increases,[170] studies consistently have

165. *Cf. supra* note 55 and accompanying text.

166. Henri Tajfel & John C. Turner, *The Social Identity Theory of Intergroup Behavior* 7, *in* PSYCHOLOGY OF INTERGROUP RELATIONS 7, 13 (Stephen Worchel & William G. Austin eds., 1986). "Ingroup bias" is sometimes used to encompass both a tendency to favor the ingroup and a willingness to discriminate against the outgroup. *See, e.g.*, Miles Hewstone et al., *Intergroup Bias*, 53 ANN. REV. PSYCHOL. 575, 576 (2002). Though the literature is robust regarding the "ingroup-favoring" bias, see *infra* note 168, the evidence is mixed regarding the circumstances under which a group will be willing to impose negative outcomes on an outgroup. *See, e.g.*, Thomas Buhl, *Positive-Negative Asymmetry in Social Discrimination: Meta-Analytic Evidence*, 2 GROUP PROCESSES AND INTERGROUP RELATIONS 51 (1999); Amélie Mummendey et al., *Categorization is Not Enough: Intergroup Discrimination in Negative Outcome Allocation*, 28 J. EXPERIMENTAL SOC. PSYCHOL. 125, 141–42 (1992).

167. By far, the most prominent theories explaining ingroup bias are social identity theory and self-categorization theory. *See generally* Michael A. Hogg, *Intragroup Processes, Group Structure, and Social Identity*, *in* SOCIAL GROUPS & IDENTITIES: DEVELOPING THE LEGACY OF HENRI TAJFEL 65, 66–68 (W. Peter Robinson ed., 1996); Henri Tajfel, *Social Psychology of Intergroup Relations*, 33 ANN. REV. PSYCHOL. 1, 20–27 (1982); John C. Turner, *Some Current Issues in Research on Social Identity and Self-Categorization Theories*, *in* SOCIAL IDENTITY: CONTEXT, COMMITMENT, CONTENT 6 (Naomi Ellemers, Russell Spears, & Bertjan Doosje eds., 1999). However, there is mixed empirical support for some of the corollaries thought to stem from these theories. *See, e.g.*, Rupert Brown, *Social Identity Theory: Past Achievements, Current Problems and Future Challenges*, 30 EUR. J. SOC. PSYCHOL. 745 (2000); Mark Rubin & Miles Hewstone, *Social Identity Theory's Self-Esteem Hypothesis: A Review and Some Suggestions for Clarification*, 2 PERSONALITY & SOC. PSYCHOL. REV. 40 (1998). Other theories explaining ingroup bias have similarly received mixed support. For an overview, see Hewstone et al., *supra* note 166, at 580–83.

168. *See* Brian Mullen, et al., *Ingroup Bias as a Function of Salience, Relevance, and Status: An Integration*, 22 EUR. J. SOC. PSYCHOL. 103, 117 (1992); Tajfel et al., *supra* note 166, at 13.

169. Cox & Munsinger, *supra* note 149, at 99.

170. *See* André Gagnon & Richard Y. Bourhis, *Discrimination in the Minimal Group Paradigm: Social Identity or Self-Interest*, 22 PERSONALITY & SOC. PSYCHOL. BULL. 1289, 1299 (1996); Michael A. Hogg, et al., *Prototypical Similarity, Self-Categorization, and Depersonalized Attraction: A*

Washington University Open Scholarship

found that categorization itself is enough to generate ingroup bias.[171] Structural bias may be easy to dismiss when viewed as the speculation of corporate law academics without any empirical support,[172] but it is much more serious when understood as part of a broader psychological framework with substantial supporting evidence.

Professors Cox and Munsinger have undertaken the task of applying the evidence to the issue of director independence in the context of derivative litigation.[173] They sought to consider "the independent directors' ability to perceive and represent the corporate interest in evaluating a demand to the board or in serving on a special litigation committee."[174] They concluded that "several psychological mechanisms can be expected to generate subtle, but powerful, biases which result in the independent directors' reaching a decision insulating colleagues on the board from legal sanctions."[175] Their work argues forcefully that the independence of outside directors is limited.

Most salient is their discussion of ingroup bias. Cox and Munsinger argue persuasively that directors are especially prone to ingroup bias because of various factors that increase their attraction to, and identity with, the group. For example, the position of director is a highly desirable one.[176] In addition, directors tend to be relatively homogeneous and share

---

Perspective on Group Cohesiveness, 25 EUR. J. SOC. PSYCHOL. 159, 172 (1995); Stephanie Perreault & Richard Y. Bourhis, *Ethnocentrism, Social Identification, and Discrimination*, 25 PERSONALITY & SOC. PSYCHOL. BULL. 92, 100 (1999). *But see* Steve Hinkle & Rupert J. Brown, *Intergroup Comparisons and Social Identity: Some Links and Lacunae*, *in* SOCIAL IDENTITY THEORY: CONSTRUCTIVE AND CRITICAL ADVANCES 48 (Dominic Abrams & Michael A. Hogg eds., 1990).

171. In the classic studies, subjects were randomly assigned to groups based on irrelevant criteria and then asked to distribute points independently and anonymously to ingroup and outgroup members; subjects consistently favored the ingroup over the outgroup in point awards. *See, e.g.*, Henri Tajfel et al., *Social Categorization and Intergroup Behavior*, 1 EUR. J. SOC. PSYCHOL. 149 (1971). A later study showed that the pattern of favoritism persisted even when subjects knew that the group assignments were completely arbitrary. *See* Michael Billig & Henri Tajfel, *Social Categorization and Similarity in Intergroup Behavior*, 3 EUR. J. SOC. PSYCHOL. 27 (1973). As of 1982, there were "at least 30 studies which used minimal or near-minimal categorizations . . . which all show in-group-favoring bias." Tajfel, *supra* note 167, at 24. For other reviews confirming that categorization itself typically generates ingroup bias, see Marilynn B. Brewer, *In-group Bias and the Minimal Intergroup Situation: A Cognitive-Motivational Analysis*, 86 PSYCHOL. BULL. 302 (1979); and John C. Turner, *The Experimental Social Psychology of Intergroup Behavior*, *in* INTERGROUP BEHAVIOR 66, 75–84 (John C. Turner & Howard Giles eds., 1981).

172. *See* Dooley & Veasey, *supra* note 91, at 534–36 (dismissing structural bias as "pop-psychology, the logic of which is irrefutable only because it is unprovable" and "a relatively silly, but harmless, academic argument.").

173. Cox & Munsinger, *supra* note 149.

174. *Id.* at 84.

175. *Id.* at 85.

176. *Id.* at 104 ("[I]ndividuals place great value on their selection to and membership on a corporation's board . . . ."); *see also id.* at 102 ("Studies suggest that as the attractiveness of a group

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

strong cultural bonds.[177] As board members, they have a fair amount of familiarity and ongoing interaction with each other.[178] Finally, they often find themselves in situations where there may be perceived competition with out-groups.[179] Together, these factors strengthen the potential for ingroup bias significantly.[180] Policies that minimize the effect of these aggravating factors, or perhaps eliminate some of them altogether, would surely help alleviate the problem. However, no such policies could be expected to eliminate ingroup bias entirely.[181] Thus, even disinterested outside directors cannot be considered truly independent.

Other psychological forces considered by Cox and Munsinger are also relevant to the current discussion. Within-group conformity behavior, for example, is another well-documented psychological phenomenon.[182] Cox and Munsinger argue that "powerful psychological factors are at work within the boardroom, creating a cohesive, loyal, conforming ingroup that will support its members for positive and negative reasons, under low and

---

and its members increases, and as the individual places greater and greater value on the rewards derived by identification with the group or continuing membership in the group, the degree of intergroup discrimination also increases.") (footnote omitted).

177. *See* Cox & Munsinger, *supra* note 149, at 105–06 ("Even though there is a perceived 'greening' of today's boardroom in the era of the independent director, the boards of American corporations continue to be distinguished by their homogeneity. Moreover, there is a great cultural gulf between the directors and their 'adversary' in the derivative suit [i.e., shareholders].") (footnotes omitted); *see also id.* at 105 ("[C]ultural, personal, ethnic, and even linguistic similarities are factors that increase the members' mutual attraction for each other. The heightened mutual attraction among a group's members causes each member to have a stronger drive toward ethnocentrism and intergroup bias.") (footnotes omitted).

178. *See id.* at 103 ("The directors called upon to evaluate a derivative suit against their colleagues are not, and generally have not been, isolated from the suit's defendants . . . Even members of a special litigation committee who were appointed *after* the derivative suit was initiated . . . serve as directors on the full board.") (footnotes omitted); *see also id.* at 99 ("Prior or ongoing interaction between individuals . . . has been repeatedly demonstrated to be a source for strong biases favoring a familiar ingroup and correlatively disfavoring a threatening or unfamiliar outgroup.") (footnote omitted).

179. Directors as a group face many situations that can be perceived as involving competition with out-groups, including hostile takeovers and derivative litigation. This adds to the group's cohesiveness and the potential for ingroup bias. *See id.* at 101 ("[C]ompetition appears to clarify the distinctiveness of one's membership in a group so that ingroup bias is more pronounced . . . .").

180. *See id.* at 104 ("Not only does each of these biasing factors . . . contribute its individual influence to the overall strength of ingroup biasing, but when several complementary psychological factors occur together within the same person, they tend to exert extra psychological force by their coexistence. This enhanced effect is commonly referred to as synergism . . . .").

181. *See supra* note 171 and accompanying text.

182. For an overview of early research, see Robert B. Cialdini & Melanie R. Trost, *Social Influence: Social Norms, Conformity, and Compliance*, *in* 2 THE HANDBOOK OF SOCIAL PSYCHOLOGY 151 (Daniel T. Gilbert, Susan T. Fiske, & Gardner Lindzey eds., 4th ed. 1998). Other studies have provided support for a general tendency to conform attitudes to ingroup norms. *See, e.g.*, Daan Van Knippenberg & Henk Wilke, *Prototypicality of Arguments and Conformity to Ingroup Norms*, 22 EUR. J. SOC. PSYCHOL. 141 (1992); Diane M. Mackie, *Social Identification Effects in Group Polarization*, 50 J. PERSONALITY & SOC. PSYCHOL. 720 (1986).

Washington University Open Scholarship

high levels of motivation and group values."[183] Another example is choice editing. "Editing is a well-documented approach decisionmakers utilize to simplify and reduce to manageable proportions inherently complex decisions."[184] Cox and Munsinger argue that directors engage in choice editing through biased risk analyses and oversimplifications.[185] These psychological forces cannot be considered an aspect of structural bias because they affect all decision making—including when directors' interests are aligned with those of the shareholders.[186] However, they are significant because they serve to exacerbate the effect of ingroup bias.[187] Conformity behavior, for example, can limit the possibility for meaningful dissent among directors. Choice editing can allow directors to justify their preferred decisions.

The foregoing is not intended to suggest that courts are better at making business decisions than are boards of directors. Judges undoubtedly face cognitive biases of their own. Moreover, courts are not business experts.[188] Furthermore, small groups (such as boards of directors) arguably are better at making decisions than individuals (such as judges).[189] However, when they are conflicted, even groups with expertise are unreliable, and courts are called upon to take up the slack. The wisdom

183. Cox & Munsinger, *supra* note 149, at 99; *see id.* at 91–99 (discussing social needs and director service); *see also* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003) (reviewing social psychology literature on small group decision making and applying it to Enron debacle).

184. Cox & Munsinger, *supra* note 149, at 85.

185. *See id.* at 85–91.

186. This Article seeks to address only structural bias, not all forms of cognitive bias. Structural bias is a form of cognitive bias that affects decision makers with conflicts of interest. The claim is that it can be remedied by means of an unconflicted decision maker, such as a court. Other forms of cognitive bias may affect all decision makers and thus may not be remediable. Still others may affect groups more than individuals, or vice versa. Although this can raise important issues, the evidence on such biases is far more ambiguous. *Compare infra* note 189 and accompanying text *with supra* notes 168–69 and accompanying text.

187. "[W]hen several complementary psychological factors occur together within the same person, they tend to exert extra psychological force by their coexistence." Cox & Munsinger, *supra* note 149, at 104; *see also* O'Connor, *supra* note 183, at 1240 ("Social psychology emphasizes that when several factors come together, they can multiply group biases so that the effect is much greater than simply adding the factors together.").

188. *See supra* notes 30–31 and accompanying text.

189. *See generally* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002). However, the evidence on this front is not unambiguous. *See* Norbert L. Kerr, et al., *Bias in Judgment: Comparing Individuals and Groups*, 103 PSYCHOL. REV. 687, 693 (1996) ("[R]esearch conducted to date indicates that there is unlikely to be any simple, global answer to the question, 'Is group judgment more or less biased than individual judgment.'"); *see also* Cass R. Sunstein, *Hazardous Heuristics*, 70 U. CHI. L. REV. 751, 762 (2003) ("Are groups able to avoid the judgment errors made by individuals? The evidence is mixed."); Bainbridge, *supra*, at 19 ("There is contested evidence as to whether groups outperform their best member . . . .").

of the business judgment rule is not being questioned; rather, the importance of accountability is being emphasized.

In short, the claim of the psychological phenomenon theory is that structural bias prejudices directors because of their membership on the board of directors. It does not mean to suggest that directors are hopelessly biased and incapable of acting in an objectively reasonable manner. Psychological forces are not necessarily decisive with respect to any individual choice, much less with respect to an entire class of decision makers.[190] However, it does suggest that it is difficult to have confidence in directors' judgment, and that they cannot be afforded the deference of the business judgment rule.

D. Critique of Structural Bias

The theory of structural bias asserts that, in cases involving conflicts of interest, directors are inherently prejudiced in favor of each other and of management, and may, consciously or unconsciously, favor their own interests over those of shareholders. Not everyone accepts the theory. Critics have two fundamental concerns: first, they demand proof of the existence of bias; second, they would prefer an alternative to any judicial solution.

Critics often demand proof regarding the claims of structural bias. After all, it is just a theory. It would be difficult, if not impossible, to prove the existence of structural bias in any given case. This is true regardless of whether structural bias is seen as an implicit conspiracy, the effect of relationships, or a psychological phenomenon. Critics may be dismissive because the theory is conveniently impossible to disprove.[191]

---

190. Professors Cox and Munsinger's caveat is worth reproducing here:

> We are careful to observe that the studies examined do not conclude that directors are biased or that their well-documented proclivity to shield colleagues from derivative suits is the product of such bias. Indeed, this precise question remains unexplored in the social psychology literature. Also, even given our description of the many biasing agents, these studies do not tell us whether natural psychological bias is so strong that it cannot be overcome by the advocacy of plaintiff's counsel or by the directors' knowledge that their evaluations will be reviewed by a court. Minimally, however, these factors strongly suggest there is bias in the boardroom favoring colleagues and disfavoring the derivative suit plaintiff. Furthermore, the preceding description offers no support for current assumptions that "outside" directors can be expected to act impartially, absent family or financial relationship with the defendants or a direct involvement in the underlying transaction.

Cox & Munsinger, *supra* note 149, at 107–08.

191. *See, e.g.*, Dooley & Veasey, *supra* note 91, at 534 ("Were we less patient, we would be inclined to dismiss such broad brush attribution of character traits and feelings to masses of strangers as pop-psychology, the logic of which is irrefutable only because it is unprovable.").

Washington University Open Scholarship

But dismissing structural bias for that reason would be imprudent. The appropriate question is whether it makes sense to be concerned about the issue.

Confidence in directors' judgment is a prerequisite to deference.[192] Such confidence is lacking when directors' interests conflict with those of the shareholders.[193] Unfortunately, the courts have held an overly narrow understanding of what constitutes a conflict.[194] Structural bias forces a reconsideration of the issue. Each of the three paradigms proposed above demonstrates the difficulty of having confidence in directors' judgment when they face conflicts of interest, even those that do not rise to the level of self-dealing. Without such confidence, the business judgment rule is inappropriate.

Courts, however, insist upon proof before accepting a structural bias argument.[195] The burden of proof is misplaced. Circumstances implicating structural bias should be enough to move the case out of the protection of the business judgment rule. Surely it is possible, perhaps even likely, that directors will do the right thing despite structural bias—just as it is possible for a party on both sides of a transaction to behave honorably.[196] But to invoke the entire fairness test, the plaintiff only needs to show a self-dealing transaction, not an actual abuse of trust by the directors.[197] It

---

192. *See supra* note 42 and accompanying text.

193. *See supra* notes 43–44 and accompanying text.

194. *See supra* note 139 and accompanying text; *see also infra* notes 200–16 and accompanying text.

195. *See supra* notes 86–89 and accompanying text.

196. *See* 1 BLOCK ET AL., *supra* note 14, at 266–67.

As the drafters of the Model Business Corporation Act explain:

> [T]he essential character of interest conflict is often, unfortunately, misunderstood by the public and the media (and sometimes misunderstood, too, by lawyers and judges). Interest conflicts can and often do lead to baneful acts. The law regulates interest conflict transactions because experience shows that people often do yield to the temptation to advance their self-interests and, if they do, other people may be injured. That contingent fear is sufficient reason to warrant caution and to apply special standards and procedures to interest conflict transactions.

Nonetheless, it is important to keep firmly in mind that it is a contingent risk we are dealing with, that an interest conflict is not in itself a crime or a tort or necessarily injurious to others. Contrary to much popular usage, having a "conflict of interest" is not something one is "guilty of"; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest. *Id.* (quoting MODEL BUS. CORP. ACT §§ 8.60–8.63, at 8-372, introductory cmt. (2002)).

197. The courts sometimes use language that suggest otherwise. For example, the Delaware Supreme Court has stated that "self-interest, alone, is not a disqualifying factor even for a director. To disqualify a director, for rule rebuttal purposes, there must be evidence of disloyalty." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993). However, that statement assumed "that the terms of 8 *Del.C.* § 144 are met." *Id.* A self-dealing transaction normally is adequate evidence of disloyalty, without proof of actual wrong-doing. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997)

falls upon the directors to justify their behavior by establishing the fairness of the transaction. Similarly, to invoke the intermediate standards of review under *Unocal* or *Zapata*, the plaintiff need only show the appropriate class of circumstances, not a breach of fiduciary duty.[198] The same general dynamic should apply to all cases involving structural bias.

To be sure, the plaintiff should have the option of offering proof of lack of independence or actual wrongdoing. However, if the plaintiff can establish such a breach of the duty of loyalty as a matter of fact, then the entire fairness test should be applied.[199] The relevant question is whether the directors should be afforded the deference of the business judgment rule in the absence of such proof. The "realities of the situation" and the "omnipresent specter" strongly suggest that they should not. An intermediate standard of review is the appropriate solution.

Critics also argue that structural bias can be overcome in a way that would eliminate the need for judicial scrutiny. The standard way of dealing with conflicts of interest is to eliminate them by having issues decided by unconflicted parties, such as disinterested and independent directors.[200] However, legal notions of disinterestedness and independence do not adequately address conflicts of interest that are less tangible in nature.[201] In order to be considered "disinterested," "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[202] Clearly the focus is on financial benefits.[203] In order to be considered "independent," "a director's decision [must be] based on the

(citing Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

198. *See supra* Parts II.B.1 and II.B.2.

199. *See, e.g.*, *Cede & Co.*, 634 A.2d at 363 ("To disqualify a director, for [business judgment] rule rebuttal purposes, there must be evidence of disloyalty. Examples of such misconduct include, but are not limited to, the motives of entrenchment . . . .") (citations omitted). In *Beam v. Stewart*, 845 A.2d 1040, 1043 (Del. 2004), the issue was not about the appropriate standard of review, but about demand futility. However, the issues are analogous. If demand is not futile, shareholders have to make a demand of the board of directors. The board's decision is entitled to the business judgment rule. *See* Grimes v. Donald, 673 A.2d 1207, 1218–19 (Del. 1996). However, if demand is futile, shareholders are able to bring the derivative action on their own. *See* Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993).

200. *See supra* notes 72–74 and accompanying text.

201. For a recent discussion of these concepts by the Delaware Court of Chancery, see Orman v. Cullman, 794 A.2d 5, 22–25 (Del. Ch. 2002) (defining and distinguishing "interest" and "independence").

202. *Id.* at 23 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

203. In fact, its focus on financial benefits is unduly narrow. Structural bias as implicit conspiracy is concerned with financial benefits, but is not covered by an approach that only focuses on financial benefits. *See supra* Part III.A.

Washington University Open Scholarship

corporate merits of the subject before the board rather than extraneous considerations or influences."[204] On its face, this definition would seem to be broad enough to extend beyond financial benefits. In fact, however, it does not go very far at all. The inquiry is whether the director is "controlled by"[205] or "beholden to" another such that "[her] discretion would be sterilized."[206] A concept as subtle as structural bias—whether as implicit conspiracy, as relationship, or as psychological phenomenon—generally is not covered.

Moreover, the question courts now ask is not whether all of the directors qualify as disinterested and independent, but rather whether the *board of directors* does. Thus, the plaintiff generally must establish that a majority of the directors is interested or lacks independence.[207] Even then, the board could avoid the entire fairness test by appointing a committee of disinterested and independent directors to decide the issue.[208] This is far too deferential in light of the need for accountability.

Until recently, it was assumed that a board consisting of a majority of outside directors could be trusted to make decisions in the interests of

---

204. *Orman*, 794 A.2d at 24 (quoting *Aronson*, 473 A.2d at 816).

205. *See Orman*, 794 A.2d at 24 (citing *Aronson*, 473 A.2d at 815–16).

206. *See id.* (quoting *Rales*, 634 A.2d at 936).

> [Independence] . . . involves an inquiry into whether the director's decision resulted from that director being *controlled* by another. A director can be controlled by another if in fact he is *dominated* by that other party, whether through close personal or familial relationship or through force of will. A director can also be controlled by another if the challenged director is *beholden* to the allegedly controlling entity. A director may be considered beholden to (and thus controlled by) another when the allegedly controlling entity has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively.

Id. at 25 n.50.

207. *See Aronson*, 473 A.2d at 815 & n.8.

> As a general matter, the business judgment rule presumption that a board acted loyally can be rebutted by alleging facts which, if accepted as true, establish that the *board* was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders. . . . To rebut successfully business judgment presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating "that a *majority* of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director."

Orman, 794 A.2d at 22 (footnotes omitted). *But see id.* ("I recognize situations can exist when the material interest of a number of directors *less* than a majority may rebut the business judgment presumption and lead to an entire fairness review.").

208. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). *See generally supra* Part I.B.1.

shareholders. The recent financial scandals have exposed this fallacy. Enron's collapse is particularly instructive: Enron's board of directors was considered to be among the best in corporate America,[209] and yet it proved to be a surprisingly ineffective monitor of management.[210] Surely it is better to have decisions made by independent directors, under nearly any definition, than by interested parties. However, it is inappropriate to assume that such directors are truly unconflicted.[211]

In response to recent events, the definition of independence has undergone revision on many fronts. The Sarbanes-Oxley Act of 2002[212] imposed stricter independence requirements for directors on audit committees,[213] and the New York Stock Exchange and the Nasdaq Stock Market strengthened their own director independence requirements as well.[214] It is arguable that courts, too, are taking a second look at these

---

209. *See* Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, *in* Nancy B. Rapoport & Bala G. Dharan, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495, 504–05 (2004).

> [B]y all appearances, Enron's board looked great. Of Enron's 14 directors, only two (Kenneth Lay and Jeffrey Skilling) were insiders. The directors reflected a wide range of business, finance, accounting, and government experience. The board had all the committees one would hope to see . . . . Perhaps most important to the board's monitoring role, the Enron audit committee had a model charter and was chaired by a former accounting professor who had served as the Dean of the Stanford Graduate School of Business.

Id. (footnotes omitted).

210. *See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, U.S. SENATE, 107TH CONG., S. PRT. 107-70, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE (2002) [hereinafter SUBCOMMITTEE REPORT]. The Senate Subcommittee found that, although Enron's board had a "wealth of sophisticated business and investment experience and considerable expertise in accounting, derivatives, and structured finance," *id.* at 8, it "failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation," *id.* at 11; *see also* WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 22–24 (Feb. 1, 2002). "[T]he Board of Directors failed, in our judgment, in its oversight duties." *Id.* at 22.

211. Even setting aside structural bias, notions of what qualifies as a financial conflict continually evolve. For example, although Enron's board of directors mostly consisted of outsiders, see ENRON CORP. PROXY STATEMENT 3–7 (2001), and seemed the model of good corporate governance at the time, see *supra* note 209 and accompanying text, subsequent investigations found significant financial ties that reduced directors' independence. *See* SUBCOMMITTEE REPORT, *supra* note 210, at 51–53 (discussing financial ties that reduced board independence).

212. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

213. *See id.* § 301, 116 Stat. at 775–76; *see also* Exchange Act Rule 10A-3, 17 C.F.R. § 240.10A-3 (2004). The Act's provisions dealing with auditor independence were far more extensive. *See* §§ 201–209, 116 Stat. at 745, 771–75 (2002); *see also* Strengthening the Commission's Requirements Regarding Auditor Independence, Release No. 33-8183, 34-47,265, 35-27,642, IC-25,915, IA-2103, 68 Fed. Reg. 6006 (Feb. 5, 2003) (codified at 17 C.F.R. pts. 210, 240, 249, and 274 (2003)), *available at* http://www.sec.gov/ rules/final/33-8183.htm.

214. *See* N.Y. STOCK EXCH. LISTED COMPANY MANUAL § 303A; NASDAQ STOCK MARKET,

Washington University Open Scholarship

concepts.[215] Such efforts clearly are worthwhile: the less conflicted the decision maker, the more appropriate it is to have confidence in her business judgment. However, the changes that have been made are not revolutionary; they merely extend the reach of the restrictions along existing lines.[216] The concepts of disinterestedness and independence remain focused primarily on financial ties and, to that extent, remain inadequate.

It is worth emphasizing that structural bias does not amount to an "implicit rejection of the value of disinterested outside directors;"[217] nor does it suggest that "there is no relevant distinction between inside and outside directors."[218] The theory of structural bias merely recognizes the limits of director independence. When a conflict arises, it may be possible to find directors who are entirely disinterested from a financial perspective (although the implicit conspiracy theory suggests otherwise),[219] but it is virtually impossible for directors to be unconflicted in all meaningful respects. The concept of structural bias instructs that less obvious conflicts must be taken seriously, and an intermediate standard of review is necessary to deal with them.

IV. REVIEW FOR SUBSTANTIVE REASONABLENESS

The business judgment rule and the entire fairness test are complementary doctrines. The key insight of the former is that directors generally can be trusted; that is why its judicial review is so deferential. The key insight of the latter is that directors cannot be trusted when they are conflicted; that is why its judicial review is so exacting. The extreme divergence between the two standards of review, however, means that there are bound to be situations in which neither seems quite appropriate. It was argued above that structural bias is the root of the problem: there are many situations which do not involve self-dealing transactions and yet do

---

INC. MARKETPLACE RULES IM-4200, IM-4350-4.

215. *See, e.g.*, Amy Borrus, *Less Laissez-Faire in Delaware?*, BUS. WK., Mar. 22, 2004, at 80 (citing *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003), and *In re* eBay, Inc. S'holder Litig., No. C.A. 19988-NC, 2004 WL 253521 (Del. Ch. Feb. 11, 2004), as examples of Delaware courts "put[ting] independence under a microscope").

216. *See* BEBCHUK & FRIED, *supra* note 149, at 25 ("Although these new requirements have attracted a great deal of attention, . . . they merely make mandatory a practice that most public companies already have been following for some time. Thus it seems unlikely that these new requirements, by themselves, will greatly change the relationship between executives and their boards.").

217. Dooley & Veasey, *supra* note 91, at 535.

218. *Id.*

219. *See supra* notes 148–51 and accompanying text.

involve serious conflicts of interest. In such situations, a balance must be struck between the deference of the business judgment rule and the rigor of the entire fairness test: judicial review must be meaningful, but not excessive.

This Part will propose and defend an intermediate standard of review to address the issue of structural bias. It will begin by arguing that a moderate review of the substance of directors' decisions best bridges the gap between the business judgment rule and the entire fairness test. It then will argue that a reasonableness standard, properly qualified, is the appropriate substantive standard. After sketching the outlines of an appropriate reasonableness standard, it will address some of the shortcomings of that standard and how they might be handled.

A. Lessons Learned

In order to devise an appropriate standard of review, one must first assess the needs that the standard is intended to serve.[220] When the standard is an intermediate one, it must bridge the gap between the two extreme standards. This section will review the lessons learned thus far in order to determine the boundaries of the endeavor.

1. Need for Substantive Review

The business judgment rule focuses primarily on the decision making process[221] while the entire fairness test carefully scrutinizes the substance of the decision itself.[222] An important question, then, is whether an intermediate standard should focus on process or substance.

It would be possible for an intermediate standard of review to focus on process. After all, the various standards of review all have a process component. The business judgment rule subjects the directors' decision making process to review for gross negligence.[223] The entire fairness test demands that the process be entirely fair.[224] An intermediate standard of review presumably should strike a balance between the two. An obvious

---

220. *See generally* Allen et al., *supra* note 3, at 867–71.

221. *See supra* note 24 and accompanying text.

222. *See supra* notes 47–48 and accompanying text.

223. *See supra* note 21 and accompanying text.

224. Actually, the demands of the entire fairness test are slightly more nuanced. It is not easy to articulate accurately either component of the entire fairness test because they are not two separate tests; rather, they must combine to produce a result that is entirely fair overall. *See supra* note 47 and accompanying text.

Washington University Open Scholarship

candidate would be an ordinary negligence standard—the typical standard for breach of duty in non-corporate settings.[225]

In fact, however, corporate standards of review generally have both a process and a substance component. The business judgment rule, for example, allows review of the substance of business decisions for irrationality or waste.[226] Although this is an extremely deferential standard, substance is not completely beyond review. The entire fairness test reviews the substance of directors' decisions for fairness.[227] Courts have recognized that the substance of a decision can be sufficiently fair that it may be treated as the preponderant consideration under the entire fairness test.[228] Thus, it is easy to view the business judgment rule as primarily concerning process and the entire fairness test as primarily concerning substance. Nevertheless, both standards have the two components.

It stands to reason, then, that an intermediate standard of review also should have both a process and a substance component. Because negligence is a logical candidate for an intermediate standard of review for process, it very well might make sense for courts to apply it in the appropriate case. However, the issue of the appropriate standard for process review will be considered later.[229]

In order to combat structural bias, an intermediate standard of review must include meaningful review of the substance of directors' decisions. Good procedures cannot guarantee good results; they can only increase the likelihood of good results. Even so, requiring directors to follow a careful decision making process is sensible because it is likely to lead to better business judgments. However, if the decision maker's good faith or loyalty is questionable, a careful process is not nearly so valuable; in the absence of good faith or loyalty, it is meaningless. If substance is beyond review, any amount of process can be overcome to reach the desired result: the decision maker need only hear the evidence before rejecting it. Minimal review of substance, such as that provided by the business judgment rule, is not much more difficult to overcome.[230]

Lawyers can be very helpful in laying the groundwork for a finding of adequate process. The case of *Smith v. Van Gorkom*[231] serves as a useful example. In that case, shareholders challenged a merger on the grounds

225. *See* RESTATEMENT (SECOND) OF TORTS § 281(b) (1965).
226. *See supra* note 23 and accompanying text.
227. *See supra* note 224 and accompanying text.
228. *See supra* note 48 and accompanying text.
229. *See infra* notes 301–02 and accompanying text.
230. *Cf. supra* notes 67–70 and accompanying text.
231. 488 A.2d 858 (Del. 1985).

that directors had breached their duty of care in approving the transaction. The Delaware Supreme Court found for the plaintiffs.[232] In the course of its opinion, the court admonished the directors for a number of procedural shortcomings: the meeting at which the decision was made was too short; there was insufficient advance notice; the directors had not read the relevant documents; and there was no fairness opinion from an investment bank.[233] The court's intuition was sensible enough: with more notice, enough time to read the documents and debate the merits of the merger, and the advice of professionals, directors are likely to reach better decisions. Even if the end result is the same, shareholders and the courts would have more confidence in the decision. The problem is that the lawyers for the directors in the next case will have read the *Van Gorkom* opinion. They will know the pitfalls and will arrange to avoid them without necessarily modifying the directors' underlying intentions or motives. Thus, the directors will be provided the relevant documents in advance—but that will not ensure that they actually will read them. They will have a longer meeting—but that will mean little if the directors feel perfectly capable of deciding the matter more quickly. They will even secure a fairness opinion from investment bankers—but a fairness opinion sought and paid for by management is not very reliable.[234] In short, process is manipulable. Lawyers can help directors appear more careful without necessarily making any meaningful changes in behavior. Directors

---

232. *Id.* at 864.

233. *See id.* at 874–76. To be fair, the court's rationale was stated broadly and did not depend entirely on the individual details listed above. However, even the court's own summary of its reasons suggests the importance of those details:

> The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

Id. at 874.

234. Investment banks have been known to provide highly questionable fairness opinions. *See, e.g.*, Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1272–73 (Del. 1989).

> Notwithstanding the fact that on May 30 both . . . had given opinions that the management restructuring, with a value of $64.15, was fair, and on June 7 had advised the board that the company had a maximum breakup value of $80 per share, [the two investment banking firms] issued new opinions on August 25 that $80 was unfair and inadequate.

Id.; *see also* William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 523–24 (1992) (listing further examples). This has led many legal scholars to question the value and reliability of such opinions generally. *See, e.g.*, Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They And What Can Be Done About It?*, 1989 DUKE L.J. 27; Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951 (1992).

Washington University Open Scholarship

almost certainly will be interested in such appearances, if only to avoid liability.[235]

Even assuming good faith on the part of directors, process is likely to be of limited usefulness if structural bias is the issue. This is true with respect to any of the three paradigms: under the weakest form of implicit conspiracy theory, directors are likely to share the same point of view;[236] under the relationship theory, directors are likely to trust their friends and colleagues;[237] and under the psychological phenomenon theory, directors are likely to favor the ingroup unconsciously.[238] After any amount of process, directors will have a tendency to come to the same conclusions. It is this tendency that undermines confidence in directors' judgment and demands recourse to a substantive review of their decisions.

The key insight of the entire fairness test is that directors cannot be trusted when they face conflicts of interest.[239] With the entire fairness test, the courts wisely recognized that they must step in and review not only the decision making process, but also the substance of the business decision in question. Although courts may be unqualified to do so,[240] conflicted directors are even worse.[241] This logic is as applicable to structural bias as it is to self-dealing. The only difference is one of degree: just as structural bias is not necessarily as acute a problem as self-dealing, so the substantive scrutiny in an intermediate standard of review need not be as strict as in the entire fairness test.

2. *Need for Latitude*

Situations involving structural bias often are very different than situations involving self-dealing. Self-dealing transactions usually can be avoided altogether. In fact, historically they were not permitted; eventually they were allowed because they can be beneficial to the corporation.[242] To protect against abuse by the conflicted party, however, the courts review such transactions for fairness. Nevertheless, self-dealing transactions

235. Directors often will not personally be liable for breaches of the duty of care because of charter provisions adopted pursuant to statutory authorization. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). However, even directors who cannot be held financially liable nevertheless will be interested in avoiding the embarrassment that would follow a holding of carelessness.

236. *See supra* notes 147–51 and accompanying text.

237. *See supra* notes 158, 162 and accompanying text.

238. *See supra* notes 166–71 and accompanying text.

239. *See supra* notes 43–44 and accompanying text.

240. *See supra* notes 28–31 and accompanying text.

241. *See supra* notes 44, 54–55 and accompanying text.

242. *See supra* notes 56–57 and accompanying text.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

remain optional, and could be restricted in any number of ways or outlawed altogether.

Situations involving structural bias generally are not avoidable. Often, they are initiated by third parties and require a response by the directors. Takeovers and derivative litigation are examples. Sometimes the situation is not initiated by third parties, as with executive compensation decisions. Even then, however, the situation is not avoidable and absolutely demands the business judgment of directors. In order to respond appropriately, directors need the kind of discretion and freedom that is provided by the business judgment rule.[243] The problem is that there is a conflict of interest, so the deference of the business judgment rule is inappropriate.

In situations involving self-dealing, strict scrutiny under the entire fairness test makes sense. After all, the alternative would be a blanket prohibition. A compromise that allows a transaction to proceed only if the court is persuaded of the merits of the transaction is an improvement from the directors' perspective. Directors can avoid the scrutiny simply by avoiding the transaction that gives rise to it. In situations involving structural bias, however, the entire fairness test makes less sense. Directors do not have the option of avoiding such situations, nor can the courts or the legislature issue a blanket prohibition. External circumstances simply demand the exercise of the directors' business judgment. Court involvement is much more of an interference, and therefore must be carefully circumscribed. Applying the entire fairness test could prove disastrous because of the possibility that no response could be defensible as "entirely fair."[244] While it makes sense to have directors hesitate to engage in self-dealing unless they can establish that the transaction is entirely fair, it would be unwise to make directors too hesitant with respect to situations involving structural bias. Thus, the courts must afford directors significant latitude for the exercise of discretion.

Of course, too much deference is also problematic. In situations involving structural bias, the business judgment rule is inappropriate because directors are conflicted. It is not clear that the judgment of a conflicted expert is better than the judgment of an impartial layman. Courts must take this into account in setting the appropriate level of scrutiny.

---

243. *See supra* note 101 and accompanying text.
244. *See supra* note 63 and accompanying text.

Washington University Open Scholarship

B. Substantive Reasonableness

The discussion thus far indicates that any standard addressing structural bias must go beyond mere process and inquire into the substance of the actions taken, while also affording directors significant latitude for the exercise of discretion.[245] Thus, what is needed is a moderate review of the substance of the directors' decisions. A review for substantive reasonableness, properly implemented, fits this role neatly.

1. Outlines of Reasonableness

In order to maintain a claim in a situation involving structural bias, the plaintiff should have to establish that the directors' decision was unreasonable. Reasonableness is a concept with which the corporate lawyer is acquainted already. Thus, familiar concepts should help in sketching the outlines of the appropriate intermediate standard.

To begin, reasonableness is a standard that is significantly more demanding than the business judgment rule's rationality standard.[246] The American Law Institute's explanation of the distinction is a helpful one:

> It is recognized that the word "rational," which is widely used by courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred.[247]

---

245. *See supra* Part IV.A.

246. It has been said that the substantive review of the business judgment rule is limited to decisions that are "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." *In re* J.P. Stevens & Co., Inc., 542 A.2d 770, 780–81 (Del. Ch. 1988), *cited in* Parnes v. Bally Entm't. Corp., 722 A.2d 1243, 1246 (Del. 1999); *see also* Allen, *supra* note 3, at 868 ("[T]he business judgment review standard ('rationality') diverges from, and [is] more lenient than, the normative standard of conduct ('reasonableness')."); Eisenberg, *supra* note 18, at 442–43 ("[T]he prevalent formulation of the standard of review [for substance] under the business judgment rule . . . is that the decision must be rational. This rationality standard of review is much easier to satisfy than a prudence or reasonability standard.").

247. 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 15, § 4.01 cmt.; *see also id.*, Comment to § 4.01(c) cmt. f ("Sound public policy dictates that directors and officers be given greater protection than courts and commentators using a 'reasonableness' test would afford. Indeed, some

Almost any decision reached by a competent board of directors ought to be considered rational: it is hard to imagine such a board coming to "a decision that cannot be coherently explained."[248] It is not nearly so problematic to suggest that a board decision is objectively unreasonable. This is because, while most actors behave rationally most of the time, many actors behave unreasonably at least some of the time.[249] Thus, review for substantive reasonableness would limit the opportunity of conflicted directors to misbehave more meaningfully than the business judgment rule.

However, a reasonableness standard does not require that decisions be ideal; even the entire fairness test does not demand perfection.[250] Rather, a reasonableness standard demands only that the decision be one that a prudent and impartial decision maker could realistically—as opposed to merely hypothetically—consider wise. Thus, the plaintiff should have to establish that the decision reached by the board of directors was one that could not be expected of a prudent and impartial decision maker.

The proposed standard would allow directors a considerable amount of discretion. The intended latitude is captured suitably by a portion of the Delaware Supreme Court's discussion of the "range of reasonableness" under the *Unocal* test:[251]

---

courts and commentators, even when using a 'reasonableness' test, have expressly indicated that they do not intend that business judgments be given the rigorous review that the word 'reasonable' may be read to imply."). *But cf.* William T. Allen, et al., *Realigning the Standard of Review of Director Due Care With Delaware Public Policy: A Critique of* Van Gorkom *and its Progeny As a Standard of Review Problem*, 96 NW. U. L. REV. 449, 452 n.13 (2002) ("Admittedly, the distinction between 'reasonable' and 'rational' actions is often subtle and elusive to grasp. Linguistically, it is odd to think of a board decision as unreasonable yet 'rational,' since both concepts rest in great part on whether the conduct was logical in the circumstances.").

248. Eisenberg, *supra* note 18, at 443. This is why the business judgment rule is so deferential. *See supra* notes 22–25 and accompanying text.

249. *See* Allen et al., *supra* note 247, at 452 ("[A]n irrational decision [is] one that is so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it. By contrast, even the best of us will occasionally make a lapse in judgment or a factual error that a judge could later second-guess as 'unreasonable' . . . ."); Eisenberg, *supra* note 18, at 443 ("To see how exceptional a rationality standard is, we need only think about the judgments we make in everyday life. It is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational."); *see also* Neil MacCormick, *Reasonableness and Objectivity*, 74 NOTRE DAME L. REV. 1575, 1580 (1999) ("Perfectly reasonable people would doubtless be unreal paragons of virtue. There are few to be found. Ordinary people are not; but most are reasonable some of the time and some are reasonable most of the time.").

250. *See* Pepper v. Litton, 308 U.S. 295, 306–07 (1930) ("The essence of the test [of intrinsic fairness] is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995) ("A finding of perfection is not a *sine qua non* in an entire fairness analysis.") (citing Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983)).

251. *But see infra* notes 259–64 and accompanying text.

Washington University Open Scholarship

> [A] court applying judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision. If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts . . . will determine if the directors' decision was, on balance, within a range of reasonableness.[252]

Reasonableness is a relational concept.[253] Thus, the circumstances of the board's decision must be considered. Factors such as uncertainty, time pressure, and available options should factor into the analysis. Also important would be the extent of the directors' independence:[254] a close call might be deemed reasonable if it were to come from a newly appointed director who has had no contacts with the company or its directors, and unreasonable if it were to come from the defendant's college roommate. However, it cannot be forgotten that the very reason for the intermediate standard of review is that all directors share in structural bias to some extent.[255]

Review for substantive reasonableness satisfies the two criteria specified above.[256] First, it inquires into the substantive merits of the directors' decision. Regardless of the process employed by the directors, decisions that are unreasonable will not be upheld. Thus, biases, whether conscious or unconscious, will not go unchecked. Second, it affords a significant amount of latitude without being overly deferential. Plaintiffs will prevail only if they can establish that the directors' decisions were unreasonable, in the sense of being outside the range of reasonableness.

---

252. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1385–86 (Del. 1995) (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1994)); *see also* MacCormick, *supra* note 249, at 1582 ("[O]n some questions, or in relation to some decisions, there may be more than one reasonable answer or, at least, a range of answers that cannot be shown to be, or dismissed as, unreasonable.").

An important part of the quote in the text has been omitted deliberately. *See infra* note 260 and accompanying text.

253. *See* MacCormick, *supra* note 249, at 1577.

> A value like "reasonable" may be very context-sensitive . . . . [T]here may be many factors which in any given situation have to be considered and assessed in judging the reasonableness of an act . . . or a decision in its concrete context. For this reason and in this sense, "reasonableness" taken out of context is . . . a "legal category of indeterminate reference."

Id.

254. Independence is not a binary issue. A disinterested outsider is more independent than a disinterested insider, and one disinterested outsider may be more independent than another.

255. *See supra* Part III.

256. *See supra* note 245 and accompanying text.

Thus, review for substantive reasonableness charts a middle course between the business judgment rule and the entire fairness test.

2. Hostile Takeover and Derivative Litigation Standards Distinguished

It is important to note that the proposed standard of substantive reasonableness is not one that already has been adopted by the Delaware courts.[257] Despite the fact that the term "reasonable" is employed with respect to the existing intermediate standards of review, the proposed standard is significantly different.

Under the second prong of the *Unocal* test, which is known as the proportionality test, the court purports to determine whether the actions taken fall within a "range of reasonableness."[258] The concept was a promising one, and some of the discussion was quoted above.[259] However, in a portion of the discussion omitted from the above quote, the court stated clearly that, under the proportionality test, "Courts will not substitute their business judgment for that of directors . . . ."[260] This sort of deference is very reminiscent of the business judgment rule, and is inappropriate when structural bias is an issue. The Delaware Supreme Court went on to dilute the standard further. In *Unitrin, Inc. v. American General Corp.*,[261] the court recharacterized the proportionality test by suggesting that non-draconian defenses are to be deemed reasonable.[262] This is an unfortunate non-sequitur: while draconian action may be unreasonable per se,[263] it does not follow that non-draconian action is necessarily reasonable. Thus, the court reduced the proportionality test to the limited role of screening out only the most extreme behavior.[264]

---

257. *Cf. In re* PSE&G S'holders Litig., 801 A.2d 295, 312 (N.J. 2002) (adopting "a modified business judgment rule" that inquires into the reasonableness of the board's decision).

258. *See supra* notes 105, 107 and accompanying text.

259. *See supra* notes 251–52 and accompanying text.

260. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995) (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45–46 (Del. 1994)); *see also Unitrin*, 651 A.2d at 1388 ("The *ratio decidendi* for the 'range of reasonableness' standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint.").

261. 651 A.2d 1361 (Del. 1995).

262. *See supra* notes 109–10 and accompanying text.

263. It is also not clear that draconian action is necessarily unreasonable. *See* Velasco, *supra* note 96, at 420 & n.245 (arguing that *Unocal* itself involved draconian defenses that were reasonable under the circumstances); *see also infra* notes 316–22 and accompanying text.

264. The *Unocal* test arguably does not even screen out draconian defenses very well. *See* Velasco, *supra* note 96, at 422 (arguing that poison pill, often upheld under *Unocal*, is draconian); *see also infra* notes 335–47 and accompanying text.

Washington University Open Scholarship

The standard proposed in this Article would have significantly more bite. Aware of structural bias, the courts should not be overly concerned with substituting their own business judgment for that of conflicted directors. They should, with confidence, determine whether the decision in question was unreasonable under the circumstances. The only deference that courts should show would come from the breadth of the term "reasonable"—which is significant, but not boundless. The extreme deference that would normally be afforded to directors under the business judgment rule should not apply.[265]

Despite the inevitable concerns, review for substantive reasonableness would not amount to a substitution of a court's business judgment for that of directors. In this respect, it differs significantly from the *Zapata* test.[266] *Zapata* provides that, after a review of the directors' independence and the procedures employed, the courts are empowered to reject the directors' decision and apply their own business judgment in reaching a different decision if they conclude that the circumstances warrant.[267] This is justly criticized on the grounds that courts do not have the appropriate skills to make business judgments.[268]

Under *Zapata*, courts are authorized to reject the independent directors' decision in favor of a superior one.[269] Review for substantive reasonableness is very different. Rather than make their own business judgments, courts merely review the directors' decisions and reject those that are shown to be unreasonable. It is not a substitution of a superior decision, only the rejection of a demonstrably poor one. This is the type of exercise with respect to which courts are competent. It is the same exercise as in the entire fairness test, where directors are required to defend their actions and courts are required to decide whether they have done so.[270] The difference between the entire fairness test and review for substantive reasonableness is the burden imposed on directors: in the former, directors must establish that their actions were entirely fair, while in the latter, directors must only defend their decisions as not unreasonable.

The judicial standards for derivative litigation must be distinguished from the proposed standard in another important respect as well. In *Aronson v. Lewis*,[271] the Delaware Supreme Court announced a

265. *See supra* note 44 and accompanying text.
266. *See supra* Part II.B.1.
267. *See supra* notes 118–21 and accompanying text.
268. *See supra* notes 122–23 and accompanying text.
269. *See supra* text accompanying note 121.
270. *See supra* notes 46–49 and accompanying text.
271. 473 A.2d 805 (Del. 1984). This case is discussed at *supra* notes 76–79 and accompanying

"reasonable doubt" standard to determine whether demand should be considered futile.[272] The standard of reasonableness in *Aronson* is entirely unlike that in the proposed standard. Although the *Aronson* court stated that "the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof,"[273] the second inquiry does not amount to a review for substantive reasonableness.

In the case of *Grimes v. Donald*,[274] the court reaffirmed the *Aronson* "reasonable doubt" standard[275] and elaborated on its meaning: "Reasonable doubt can be said to mean that there is reason to doubt."[276] This is not particularly helpful. However, the court continued: "Stated obversely, the concept of reasonable doubt is akin to the concept that the stockholder has a 'reasonable belief' that the board lacks independence or that the transaction was not protected by the business judgment rule."[277] This is hardly an obvious interpretation of "reasonable doubt": to doubt a fact is not the same as to believe the opposite fact. This standard sets a very high threshold for the plaintiff who, it seems, must justify as reasonable not merely skepticism, but an affirmative belief.

In the case of *Beam v. Stewart*,[278] the Delaware Supreme Court addressed the issue of "the quantum of doubt about a director's independence that is 'reasonable' in order to excuse a presuit demand."[279] The court framed the issue in terms of the strong presumption of the business judgment rule and held that "[t]he court must determine whether a plaintiff has alleged particularized facts creating a reasonable doubt of a director's independence *to rebut the presumption* at the pleading stage."[280] This burden is difficult to meet because the presumption that must be rebutted is powerful.[281] Moreover, in the course of their analyses, both the Delaware Supreme Court and the Court of Chancery italicized the term reasonable, apparently in an effort to highlight the fact that not all doubts

---

text.

272. *See supra* note 78 and accompanying text.
273. *See Aronson*, 473 A.2d at 814.
274. 673 A.2d 1207 (Del. 1996).
275. *See Grimes*, 673 A.2d at 1217 ("[T]he term is apt and achieves the proper balance.").
276. *Id.*
277. *Id.* at 1217 n.17.
278. 845 A.2d 1040 (Del. 2004). This case is discussed at *supra* notes 80–89 and accompanying text.
279. *Stewart*, 845 A.2d at 1048.
280. *Id.* at 1049 (emphasis added).
281. *See supra* note 17 and accompanying text.

Washington University Open Scholarship

are sufficient to rebut the presumption.[282] The ultimate holding in the case confirmed the demanding nature of the standard.[283]

The proposed standard of substantive reasonableness is nothing like Delaware's reasonable doubt standard. In the first place, the presumption of the business judgment rule would not be applied. Moreover, the two standards evince a very different understanding of the breadth of the term "reasonableness." To those familiar with criminal law, the term "reasonable doubt" suggests a very low standard.[284] A small doubt will suffice, although not a fanciful one.[285] Delaware's reasonable doubt standard bears no relation to that standard;[286] only a doubt with a solid foundation seems to qualify. The criminal law standard is far more consistent with an ordinary interpretation of reasonableness in that it allows the doubter considerable latitude, while Delaware's standard does not.

Ultimately, the Delaware reasonable doubt standard should be scrapped. As has been argued, the proposed standard of substantive

---

282. *Stewart*, 845 A.2d at 1051 ("[Courts] must review the complaint . . . to determine whether it states with particularity facts indicating that a relationship . . . is so close that the director's independence may *reasonably* be doubted."); *id.* at 1050 (quoting Beam v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003)) ("Some professional or personal friendships . . . may raise a reasonable doubt whether a director can appropriately consider demand. . . . Not all friendships, or even most of them, rise to this level and the Court cannot make a *reasonable* inference that a particular friendship does so without specific factual allegations to support such a conclusion.").

283. The court found that the facts did not create a reasonable doubt about directors' independence and so demand was not futile. *See supra* note 89 and accompanying text.

284. *See generally* Victor v. Nebraska, 511 U.S. 1 (1994). *See also* Cage v. Louisiana, 498 U.S. 39, 41 (1990) ("[T]he words 'substantial' and 'grave,' as they are commonly understood, suggest a higher degree of doubt than is required for acquittal under the reasonable-doubt standard."). Actually, criminal law is more accustomed to speaking of the standard "beyond a reasonable doubt" as a very high standard. *See, e.g.*, Jackson v. Virginia, 443 U.S. 307, 315 (1979) ("a subjective state of near certitude"), which is the corollary of a very low standard for reasonable doubt.

285. *Compare Victor*, 511 U.S. at 20 (describing reasonable doubt as "a doubt that would cause a reasonable person to hesitate to act"), *with id.* at 17 ("A fanciful doubt is not a reasonable doubt.").

286. Judge Easterbrook of the United States Court of Appeals for the Seventh Circuit expressed his frustration with the *Aronson* standard as follows:

> The reference to "reasonable doubt" summons up the standard applied in criminal law. It is a demanding standard, meaning at least a 90% likelihood that the defendant is guilty. If "reasonable doubt" in the *Aronson* formula means the same thing as "reasonable doubt" in criminal law, then demand is excused whenever there is a 10% chance that the original transaction is not protected by the business judgment rule. Why should demand be excused on such a slight showing? Surely not because courts want shareholders to file suit whenever there is an 11% likelihood that the business judgment rule will not protect a transaction. *Aronson* did not say, and later cases have not supplied the deficit. If "reasonable doubt" in corporate law means something different from "reasonable doubt" in criminal law, however, what is the difference?, and why use the same term for two different things?

Starrels v. First Nat'l Bank of Chicago, 870 F.2d 1168, 1175 (7th Cir. 1989) (Easterbrook, J., concurring) (citations omitted).

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

reasonableness should be applied in all cases involving structural bias. As will be argued, that includes all decisions relating to derivative litigation, whatever the setting.[287] Thus, the proposed standard will supplant not only the *Zapata* test, but also the *Aronson* test.[288] There will be no need for the reasonable doubt standard.

C. Shortcomings

Critics are likely to raise at least three arguments against the proposed standard, all of which are rooted in the indeterminate nature of the concept of reasonableness. The first is that a reasonableness standard is too amorphous and does not provide much guidance. The second is that a reasonableness standard is too malleable and capable of collapsing into the business judgment rule. The third is that implementing a reasonableness standard would be too costly for society because of the increase in litigation expenses that it may occasion. Each of these arguments will be considered in turn.

Some critics may complain that a reasonableness standard is too amorphous and does not provide much guidance. While reasonableness is an objective standard, it can "be applied only as mediated through the subjectivity of the judge."[289] However, the same could be said for virtually any standard, including "fairness."[290] Courts are required to apply indeterminate standards all the time. While directors might prefer more certainty, so would any other fiduciary or potential litigant—but the business judgment rule is not available to provide special treatment.[291]

In any event, the proposed standard is not so indeterminate. Because the range of reasonableness affords the directors significant latitude, the proposed standard should neither be too difficult for the courts to apply nor involve the courts in business affairs too heavily. It is more likely that courts would err on the side of less intrusion. Too little accountability for directors would not be warranted. However, as long as the standard, as applied, does not approach the deference of the business judgment rule's

---

287. *See infra* notes 370–71 and accompanying text.

288. *See infra* notes 372–76 and accompanying text.

289. *See* MacCormick, *supra* note 249, at 1576.

290. *See* Mitchell, *supra* note 137, at 444 ("The attempt to identify and articulate the content of the fairness test is, predictably, frustrating. Courts and commentators long have decried this ephemeral nature of the standard, but efforts to make the test more determinate . . . themselves have dissolved into indeterminacy . . .").

291. It is only the business judgment rule that gives directors a greater claim to deference than other fiduciaries such as doctors, attorneys, or auditors. *Cf. supra* notes 38–41 and accompanying text.

Washington University Open Scholarship

rationality standard, there would be some benefit to an intermediate standard.[292]

Other critics may complain that the standard is too malleable and capable of collapsing into the business judgment rule. *Unocal*, for example, sounded promising at first and later proved to be relatively ineffectual.[293] Adopting a test that sounds a lot like the *Unocal* test could easily lead to a similar result. However, the court in *Unocal* laid the seeds of the standard's destruction from the beginning.[294] By tying the test so closely to the business judgment rule, the court doomed *Unocal* to be of limited significance.[295] The standard proposed in this Article is born of the need for a truly intermediate standard of review and is firmly ensconced between the business judgment rule and the entire fairness test. In fact, the deference of the business judgment rule, which was the downfall of the *Unocal* standard, is explicitly rejected because of the directors' conflicting interests.[296] In that sense, the proposed standard resembles the entire fairness test. Thus, it should not be as easy for the proposed standard to drift towards the business judgment rule.[297]

The third and most significant critique of the reasonableness standard is that its adoption would be too costly for society because of an associated increase in litigation expenses.[298] It cannot be denied that replacing the business judgment rule with an intermediate standard of review would be likely to cause an increase in litigation expenses, at least at the margin. The number of lawsuits filed would increase because litigants (or litigators) who do not foresee a reasonable opportunity for success under the business judgment rule may come to a different conclusion under a review for substantive reasonableness. However, the proposed standard should not have a dramatic effect on the legal landscape or corresponding

292. *Cf.* MacCormick, *supra* note 249, at 1586–87 ("Even though different people can come to different evaluations in . . . questions of balance, and a variety of evaluations could be accepted as falling within the range of reasonable opinions . . . the range has some limits. Some opinions are so eccentric or idiosyncratic that they are not accepted as valid judgments at all.").

293. *See supra* notes 103–10 and accompanying text.

294. *See, e.g.*, *supra* notes 106, 260 and accompanying text.

295. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("[T]he business judgment rule, including the standards by which director conduct is judged, is applicable in the context of a takeover."); *id.* at 955 ("[Directors] satisfy that burden 'by showing good faith and reasonable investigation . . . .'") (citation omitted); *id.* at 957 ("If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment.").

296. *See supra* text accompanying note 265.

297. Of course, a determined court could easily make this happen. But a determined court likely would never adopt the proposed standard in the first place.

298. *Cf. supra* note 64 and accompanying text.

litigation volume and expense. The proposed standard would extend the reach of judicial review modestly beyond the business judgment rule, which currently covers only the most extreme circumstances. Under the proposed standard, the vast majority of business decisions should be upheld without difficulty.

Nevertheless, critics will maintain that, despite the intention, a significant increase in litigation expenses would be the inevitable result. This is because reasonableness seems to be a question of fact: as such, it generally could not be decided on the pleadings and often would require a trial. Thus, the cost of defending against lawsuits would increase dramatically because many cases that would have been dismissed on the pleadings under the business judgment rule would survive motions for summary judgment under the proposed standard. The expense and disruption involved with discovery and trial are considerable. Because situations involving structural bias are far more common than situations in which judicial interference is ultimately justified,[299] critics may argue that adopting the proposed standard would not benefit shareholders or society.

This concern is a valid one, but does not carry the day. The business judgment rule permits dismissal of many cases, which allows for tremendous savings in litigation expenses. The entire fairness test, on the other hand, generally does not permit dismissal and does require significant expenditures on litigation.[300] The increase in litigation costs is great, but justified based on the relative estimates of the merits of the underlying claims, the need for accountability, and the benefits that can be expected from litigation. Similarly, an intermediate standard would be worthwhile if the benefits of litigation justify the increased cost.

Because the proposed standard is intended to have a relatively modest effect on plaintiffs' chances for success on the merits, it ought to minimize wasteful litigation expenses by preserving the ability of the courts to grant dismissals and summary judgments in most cases.[301] An ordinary negligence standard for process review would be problematic. Negligence is a question of fact that cannot easily be resolved without a trial, and almost certainly not on the pleadings. Discovery would become routine, and trials would become common. The effect on both litigation volume

299. *See supra* notes 250–55 and accompanying text.

300. *See supra* note 64.

301. Judicial review must balance the competing values of authority and accountability. *See supra* notes 1–3 and accompanying text. Just as "losses tolerated by judicial abstention must be outweighed by benefits elsewhere in the system," Bainbridge, *Abstention Doctrine*, *supra* note 1, at 110, so too must losses tolerated by judicial intervention be outweighed by benefits elsewhere in the system.

Washington University Open Scholarship

and expense could be dramatic. By contrast, the gross negligence standard allows the courts to cut off wasteful litigation early while allowing the closer cases to proceed. Thus, a gross negligence standard for process review seems more appropriate.[302]

As for substance review, the range of reasonableness is more analogous to gross negligence than ordinary negligence. There should be a presumption that a business decision is reasonable, although the presumption would be weaker than under the business judgment rule. With such a presumption, however, the issue of reasonableness under the proposed standard can, and should, be decided as a question of law, at least as a threshold matter.[303] Treating "reasonableness" as a question of law as a threshold matter would be compatible with existing corporate law practices. The courts treat the presumption of the business judgment rule as a matter of law.[304] This is also how the courts handle the "reasonable doubt" standard in *Aronson*.[305] This treatment makes sense for the proposed standard as well, given the intended breadth of the range of reasonableness. This would allow courts to decide the issue on the pleadings in many cases. Only when the circumstances warrant—when the pleadings are sufficiently promising—would a case be permitted to proceed, forcing the company to incur the expense of discovery and trial.

Any increase in litigation expenses also would be minimized by the procedural hurdles of derivative litigation, especially the requirement of particularized allegations. As will be argued, these procedural hurdles have the effect of reducing litigation volume and expense significantly.[306] Because most cases involving structural bias must be pursued by means of derivative litigation, these procedural hurdles will help keep down litigation expenses resulting from the proposed standard.

---

302. It may be that "gross negligence," as applied by the courts is a bit too deferential. However, cases such as *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), suggest otherwise. *See* Allen et al., *supra* note 3, at 872–74 (arguing that the *Van Gorkom* court actually applied ordinary negligence standard).

Gross negligence is not the only alternative to ordinary negligence. A reasonableness standard could be employed for both the substance and process components of review, as is the case with the fairness standard. *See supra* note 47 and accompanying text.

303. Although the ultimate issue could be decided as a question of fact in close cases, the court would be able to decide, as a matter of law, whether the pleadings are sufficient to raise a legitimate issue under the proposed standard.

304. *See supra* notes 21–24 and accompanying text.

305. *See supra* notes 271–83 and accompanying text; *cf. supra* notes 284–87 and accompanying text (disagreeing with court's substantive interpretation of reasonableness). Reasonableness is also decided as a matter of law in certain other contexts, such as Fourth Amendment jurisprudence. *See, e.g.*, Ornelas v. U.S., 517 U.S. 690 (1996).

306. *See infra* notes 350–51, 359–69 and accompanying text.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

In short, the additional cost to society will not be nearly as great as may be feared. Although the cost of litigation is a serious issue, it should not be the controlling factor. Meritorious claims should not be cut off in the interests of judicial economy.[307] Savings in litigation costs come at the expense of accountability. Extreme deference may make sense when directors are unconflicted,[308] but not when self-dealing or structural bias is an issue. In such cases, the cost-benefit analysis changes radically: the value of accountability takes on greater significance vis à vis the value of authority.[309]

V. APPLICATION

In Part IV, a new intermediate standard of review for dealing with cases involving structural bias was proposed and defended. It was argued that courts should review directors' decisions for substantive reasonableness in order to provide a meaningful check on directorial bias. This Part will attempt to apply that standard in a few important situations. First, it will consider how the standard would work in the context of a hostile takeover and resulting defensive strategies employed by the target company's board of directors. The proposed standard will be contrasted with the enhanced scrutiny provided by *Unocal*. This Part then will consider how the standard would apply in the context of derivative litigation and a board's decision to terminate such litigation. How the test manages derivative litigation is particularly important because most substantive breaches of fiduciary duty are enforced by means of derivative litigation. Next, this Part will consider how the standard would work in the context of a particular substantive issue that is a common subject of derivative litigation: executive compensation. The ability to make a difference on the merits of a substantive issue is, after all, what gives meaning to the proposal. Finally, this Part will consider a very important issue with respect to structural bias claims: the applicability of charter provisions that limit directors' personal liability for breach of fiduciary duty. This issue raises the difficult question of whether structural bias should be seen as a duty of care issue or a duty of loyalty issue. The goal

---

307. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981) ("[I]f we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits. At this point, we are not convinced that is necessary or desirable.").

308. *See supra* note 18.

309. The issue is the same as with self-dealing and the entire fairness test, albeit on a smaller scale. *See supra* notes 139–44 and accompanying text.

Washington University Open Scholarship

of this Part is to demonstrate that the proposed standard is not nearly as radical as it may seem at first.[310]

A. Hostile Takeovers

The basic standard of review for takeover defenses is set forth in *Unocal Corp. v. Mesa Petroleum Co.*[311]—there must be reasonable grounds to believe there is a threat, and the response must be reasonable in relation to the threat.[312] At first glance, it may appear that there is not much of a difference between the *Unocal* standard and the standard proposed here. However, there is a great difference in the way the standard would be applied.

One way in which the proposed standard would differ from *Unocal* is that it would not necessarily require a threat. However, this is not a great point of divergence for two reasons. First, the existence of a threat would certainly factor into the circumstances under which the action in question must be deemed reasonable.[313] Second, *Unocal* has been interpreted to perceive a threat under virtually any circumstance: even when there is no actual threat, the court will recognize the potential for a hostile takeover as a threat.[314] It is the second prong that does the work under *Unocal*, and potential takeovers are circumstances that could be considered under the proposed standard. Thus, the two tests can accommodate threats equally well.

Unocal's second prong—the proportionality, or "range of reasonableness," test—is another matter. As has been argued, *Unocal* is a very deferential standard, and seems to prohibit only those defenses which would be considered draconian because they are either coercive or

---

310. An important caveat must be given at this point: the following attempts to apply the review for substantive reasonableness are not intended to be definitive. Reasonableness is an evaluative norm, and different people can come to different conclusions. *See* MacCormick, *supra* note 249, at 1581–82 ("In any question that involves weighing much evidence or many interests and values and coming to a conclusion on what may seem a relatively fine balance, it does not surprise us to find others reaching a conclusion different from our own . . . . Such a difference of judgment is no mere difference of taste . . . ."). Qualifications—such as the "range of reasonableness" formulation, see *supra* notes 251–55 and accompanying text, may help reduce variability among judges, but cannot eliminate it entirely. What follows, then, is the author's good faith effort at applying a standard of substantive reasonableness. This admission should not denigrate the value of an intermediate standard of review. *See supra* notes 289–91 and accompanying text.

311. 493 A.2d 946 (Del. 1985).

312. *See id* at 955; *see also supra* notes 95–111 and accompanying text.

313. *See supra* notes 253–54 and accompanying text.

314. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350 (Del. 1985) ("[H]ere we have a defensive mechanism adopted to ward off possible future advances . . . ."); *see also* Velasco, *supra* note 96, at 416–19.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

preclusive.[315] The proposed standard would have a greater reach. It would recognize that there are many defenses that may not be draconian but that would nevertheless be unreasonable. However, it also would recognize that some draconian defenses might nevertheless be reasonable.

The defensive measures employed in *Unocal* itself serve as a good example. In that case, Mesa Petroleum had made a two-tiered, front-loaded tender offer for the shares of Unocal.[316] The Unocal board responded to the coercive offer with a selective self-tender.[317] The court upheld the defense as reasonable under the circumstances,[318] and the proposed standard should produce the same result. However, at least as originally proposed, the defense in *Unocal* was arguably draconian. The selective self-tender was preclusive because it was made contingent upon the success of Mesa Petroleum's initial tender offer.[319] Mesa Petroleum would be unwilling to go forward in the face of the selective self-tender; as a result, there would be no selective self-tender, either. Thus, Unocal's defense would have precluded any transaction from going forward. The defense was also coercive: shareholders would be forced to accept its terms, even if opposed, because not doing so would make them worse off.[320] It was essentially a two-tiered, *back*-loaded tender offer. After *Unitrin, Inc. v. American General Corp.*,[321] such a draconian defense would not be upheld under *Unocal*.[322] Under the proposed standard, however, it could be deemed reasonable because of the coercive nature of Mesa Petroleum's offer: it would be a case of fighting fire with fire.

Paramount Communications, Inc. v. Time, Inc.[323] presents a situation in which the court upheld a defensive response that would not be upheld under the proposed standard. In that case, Time entered into a merger agreement with Warner.[324] Prior to the consummation of the transaction, Paramount stepped in with a higher offer for Time.[325] Time refused to negotiate with Paramount and instead restructured its transaction with

315. *See supra* notes 109–10, 258–65 and accompanying text.
316. *See supra* notes 96–98 and accompanying text.
317. *See supra* notes 99–100 and accompanying text.
318. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–56 (Del. 1985).
319. This requirement was later partially waived. *See id.* at 951.
320. Shareholders might be opposed to the superior terms because the offer was, in fact, preclusive. They would nevertheless tender because failure to do so would result in the same dilution that Mesa Petroleum was facing.
321. 651 A.2d 1361 (Del. 1995).
322. *See supra* notes 109–10 and accompanying text.
323. 571 A.2d 1140 (Del. 1990).
324. *Id.* at 1143–46.
325. *Id.* at 1147.

Washington University Open Scholarship

Warner so as to frustrate Paramount's efforts.[326] The court characterized this response as merely an implementation of a pre-existing strategic plan, and considered the associated defenses reasonable in relation to this limited goal.[327] In its efforts to avoid "substituting its judgment as to what is a 'better' deal for that of [the] corporation's board of directors,"[328] the court failed to appreciate how radical the restructuring of the transaction really was. Time was not merely defending its long-term strategic plan. Rather, it gave up on its proposed merger of equals in favor of an outright acquisition of Warner. This change in plans would have serious operational consequences for the company.[329] The plans were changed in order to avoid a shareholder vote that directors knew would not have been obtainable because of the superior Paramount offer.[330]

The board's conduct should not have been upheld because it was draconian: it was coercive in that it eliminated the need for shareholder approval in order to cram the transaction down the shareholders' throats;[331] it was preclusive in that it would prevent the combined company from being acquired for the foreseeable future.[332] In any event, without the business judgment rule-like deference afforded by *Unocal*,[333] the board's conduct would have been deemed unreasonable under the proposed standard. Going to such lengths to deprive the shareholders of a

---

326. *Id.* at 1146–48.

327. *Id.* at 1154–55 ("Here, on the record facts, the Chancellor found that Time's responsive action to Paramount's tender offer . . . had as its goal the carrying forward of a pre-existing transaction in an altered form. Thus, the response was reasonably related to the threat.") (footnote omitted).

328. *Id.* at 1153.

329. *Id.* at 1148 (In the restructured transaction, "Time would assume 7–10 billion dollars worth of debt, thus eliminating one of the principal transaction-related benefits of the original merger agreement."). *Compare id.* at 1145–47 (discussing advantages of original transaction) *with id.* at 1148–49 (describing restructured transaction).

330. The market valued the Time-Warner transaction at $126 per share of Time, while Paramount offered $175 per share initially, and $200 per share eventually. *Id.* at 1147–49.

331. Time had sought other ways of avoiding a shareholder vote before restructuring the merger as an acquisition. *See, e.g.*, *id.* at 1148 ("Time sought permission from the New York Stock Exchange to alter its rules and allow the Time-Warner merger to proceed without stockholder approval."); *see also supra* note 327.

332. *Compare Time*, 571 A.2d at 1154 ("Paramount argues that . . . Time's response was unreasonable in precluding Time's shareholders from accepting the tender offer or receiving a control premium in the immediately foreseeable future."), *with id*. at 1155 ("[T]he revised agreement . . . did not preclude Paramount from making an offer for the combined Time-Warner company . . . ."). Although the Time-Warner deal was not technically preclusive, it is hard to imagine any deal that is. *See* Velasco, *supra* note 96, at 421 n.251. The fact is that the size and debt burden of the combined Time-Warner would make the company acquisition-proof for years to come.

333. *See supra* notes 260–65 and accompanying text.

vote on a proposed merger may not be utterly irrational, but it is unreasonable.[334]

Judicial review of the poison pill defense could benefit from the proposed standard as well.[335] As the author has argued elsewhere, the poison pill should be considered draconian in that it is both coercive and preclusive.[336] The courts disagree: they do not consider the poison pill to be unreasonable under *Unocal*.[337] Thus, it might seem unlikely that the courts would consider the poison pill unreasonable under the proposed standard, either. However, without the deference afforded by *Unocal*, the courts should be able to see the poison pill for what it is: part of a "just say no" strategy to avoid hostile takeovers of any kind.[338]

Shareholders essentially have two rights: the right to vote and the right to sell their shares. The Delaware courts have recognized the "central importance of the [shareholder] franchise to the scheme of corporate governance."[339] Unfortunately, they have not recognized the fundamental importance of shareholder exit.[340] However, the logic is equally applicable. To paraphrase the Delaware Court of Chancery:

> A board's decision to act to prevent the shareholders from [selling their shares] does not involve the exercise of *the corporation's power* over its property, or with respect to *its* rights and obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to [property rights in the company's shares].[341]

---

334. Such conduct also is problematic under *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). Because the board intentionally interfered with a shareholder vote, it should have to demonstrate a compelling justification for its conduct. *See supra* note 111.

335. "The poison pill is the ultimate defense against a hostile takeover." Velasco, *supra* note 96, at 381. For a brief description of the poison pill, see *id.* at 383–84. For a more detailed description, see Julian Velasco, *Just Do It: An Antidote to the Poison Pill*, 52 EMORY L.J. 849, 856–68 (2003).

336. *See* Velasco, *supra* note 96, at 419–22.

337. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1351–57 (Del. 1985) (flip-over pill); *see also* Account v. Hilton Hotels Corp., 780 A.2d 245, 249–50 (Del. 2001) (reaffirming *Moran*); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1378 (Del. 1995) (flip-in pill); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180–81 (Del. 1986) (back-end pill).

338. *See* Velasco, *supra* note 96, at 384; Velasco, *supra* note 335, at 850.

339. *Blasius*, 564 A.2d at 659; *see supra* note 111.

340. *Cf.* Chesapeake Corp. v. Shore, 771 A.2d 293, 328 (Del. Ch. 2000) ("If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?"); Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 501 (2001) (arguing against Delaware court's "preference that control contests be resolved through an election, rather than a market").

341. *Blasius*, 564 A.2d at 660.

Washington University Open Scholarship

Shareholders should be able to sell their shares freely, whether on the market or in a tender offer. The company should be permitted to interfere only in the interests of shareholders—for example, when they are confronted with a coercive offer. However, when shareholders face a non-coercive offer, such as an all-cash, all-shares offer, director interference is unjustifiable.[342] A board's decision to block such an offer may be rational, in that it could allow directors to negotiate a better price for shareholders,[343] but it would not be reasonable because it allows directors to intrude upon shareholder prerogatives.

Some might disagree that the poison pill is so powerful, at least standing alone, because the hostile bidder can eliminate the poison pill by means of a successful proxy contest. Surely, however, certain variants can be preclusive—such as the dead hand poison pill.[344] Moreover, even a garden-variety poison pill can be quite potent when combined with other defenses, such as a staggered board of directors.[345] Such preclusive defenses should not be considered reasonable, even under *Unocal*.[346] Under the proposed standard, even an ordinary poison pill defense should

---

342. "The term 'all-cash, all-shares offer' generally refers to a tender offer for any and all shares of the target company's stock, with consideration to be paid in cash. There is often a promise to cash out remaining shareholders at the same price." Velasco, *supra* note 96, at 388 n.44. "[A]n all-cash, all-shares offer does not pose any real threat." *Id.* at 419.

343. *See* William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1093–96 (1999).

344. "In substance, the 'dead hand' provision operates to prevent any directors . . . , except those who were in office as of the date of the [poison pill]'s adoption . . . or their designated successors, from redeeming the [poison pill] until they expire." Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1184 (Del. Ch. 1998). The validity of the dead hand provision was called into doubt by the Delaware Court of Chancery in *Carmody*. *See id.* at 1182. A less powerful relative, the "delayed redemption provision" or "no hand" pill, was struck down by the Delaware Supreme Court in *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998). However, some other courts have upheld such provisions. *See, e.g.*, AMP, Inc. v. Allied Signal, Inc., No. 98-4405, 1998 U.S. Dist. LEXIS 15617 (E.D. Pa. Oct. 8, 1998); Invacare Corp. v. Healthdyne Techs., Inc., 968 F. Supp. 1578 (N.D. Ga. 1997).

But see Velasco, *supra* note 335, at 903 ("The antidote strategy . . . can even be successful in states where dead-hand and no-hand provisions are legal . . . .").

345. *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 STAN. L. REV. 887 (2002). *But see* Velasco, *supra* note 335, at 902 (The antidote strategy "should be able to overcome the combined effect of a poison pill together with a staggered board.").

346. The cases of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), and *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), provide specially-enhanced versions of enhanced scrutiny. *See supra* note 111. It already has been argued that those cases could be seen as mere extensions of *Unocal*. *See supra* note 111. Given business judgment rule-like deference, however, the author is skeptical that the courts would reach the same result under *Unocal*. The author is far more confident that *Revlon* and *Blasius* would be decided similarly under the proposed standard because it does not provide such extreme deference.

be considered unreasonable if it is used to prevent shareholders from selling their shares.[347]

B. Derivative Litigation

When shareholders wish to sue directors for breach of fiduciary duty, they generally must do so by means of a derivative action. This is because it is usually the company that is harmed by the directors' breach; shareholders are harmed only indirectly, through their ownership interest.[348] Because directors' decisions with respect to derivative litigation are among the key situations involving structural bias, there is an important link between the proposed standard and enforcement of all fiduciary duties.

Courts are ambivalent about derivative litigation. On the one hand, they sympathize with directors who insist that much of it is wasteful; on the other hand, they recognize the need to allow shareholders to pursue meritorious claims when conflicted directors refuse to do so.[349] The result

347. The poison pill may have a legitimate role as a temporary defensive measure, but not as part of a "just say no" defense.

> [If] the threat is defined as one involving the possibility that stockholders might make an erroneous investment or voting decision, the appropriate response would seem to be one that would remedy that problem by providing the stockholders with adequate information. The corporate board . . . may legitimately need more time to ensure that it can get its message out to the market place.

Chesapeake Corp. v. Shore, 771 A.2d 293, 325 (Del. Ch. 2000).

348. *See* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031 (Del. 2004).

> The derivative suit has been generally described as "one of the most interesting and ingenious of accountability mechanisms for large formal organizations." It enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation. Because a derivative suit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation. A stockholder who is directly injured, however, does retain the right to bring an individual action for injuries affecting his or her legal rights as a stockholder. Such a claim is distinct from an injury caused to the corporation alone. In such individual suits, the recovery or other relief flows directly to the stockholders, not to the corporation.

Id. at 1036. The Delaware Supreme Court has recently "set forth . . . the law to be applied henceforth in determining whether a stockholder's claim is derivative or direct;" *id.* at 1033. "The issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Id.*

349. The courts have engaged in this sort of balancing explicitly:

> The jurisprudence of *Aronson* and its progeny is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule.

Washington University Open Scholarship

is a body of law that could be characterized as schizophrenic. For example, derivative litigation is frustrated by requirements such as the contemporaneous ownership rule[350] and the demand requirement,[351] but facilitated by the reimbursement of litigation expenses[352] and the ability to argue demand futility.[353]

Despite their ambivalence, courts have recognized the need for meaningful review of such matters. They have struggled to find the appropriate balance between directorial authority and accountability by seeking ways to block frivolous litigation while allowing meritorious claims.[354] To do this properly, however, courts must deal adequately with structural bias. Directors' decisions with respect to derivative litigation cannot be trusted fully. However, neither can every shareholder be permitted to control the company's fate. The courts are wise in seeking structural safeguards, such as the establishment of board committees that are as independent as possible and the encouragement of solid decision-making processes. Such safeguards increase, at least to some extent, the confidence that can be had in directors' judgment. However, because of structural bias, and the limits of independence[355] and process,[356] these safeguards must be followed by meaningful judicial review.

Meaningful judicial review is expensive.[357] However, reliance upon unaccountable directors who are inherently conflicted is not a satisfactory alternative. Moreover, the cost of judicial review need not be great if

---

Grimes v. Donald, 673 A.2d 1207, 1217 (Del. 1996) (footnotes omitted).

> At the risk of stating the obvious, the problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result. . . . It thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.

Zapata Corp. v. Maldonado, 430 A.2d 779, 786–87 (Del. 1981) (citations omitted); *see also* Levine v. Smith, 591 A.2d 194, 200 (Del. 1991); Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984).

350. *See, e.g.*, DEL. CODE ANN. tit. 8, § 327 (2001).

351. *See, e.g.*, DEL. CH. CT. R. 23.1.

352. *See, e.g.*, Seinfeld v. Coker, 847 A.2d 330, 333 (Del. Ch. 2000) ("This Court consistently has held that, in . . . derivative actions, plaintiffs' counsel are entitled to an award of attorneys' fees and expenses where their efforts achieve a benefit for the corporation or its shareholders.").

353. *See, e.g.*, DEL. CH. CT. R. 23.1; *see also Aronson*, 473 A.2d at 814 (Del. 1984).

354. *See supra* note 349.

355. *See supra* notes 200–19 and accompanying text.

356. *See supra* notes 230–41 and accompanying text.

357. *See supra* notes 298–302 and accompanying text.

courts are permitted to decide the easy cases as a matter of law.[358] Finally, there are a number of procedural requirements, such as the contemporaneous ownership rule and the demand requirement, that have the effect of minimizing litigation volume and expense.[359]

One such requirement that bears special emphasis is the Delaware requirement of particularized allegations. As part of the demand requirement, the Delaware Chancery Court Rules require that "the complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[360]

A quick read might suggest that particularized allegations are necessary only with respect to demand issues. However, a more careful reading of the rule in context reveals that the requirement actually reaches the merits of the underlying claims.

In Delaware, a shareholder plaintiff in a derivative action faces a difficult decision. The plaintiff must either argue demand futility, in which case particularized allegations are necessary, or make a demand, in which case the argument of demand futility is waived and the business judgment rule is invoked.[361] Although it may be difficult to make particularized allegations, it is a better option than facing the business judgment rule on the directors' response to the demand.

The test for demand futility is a two-part test set forth in *Aronson v. Lewis*.[362] The first prong, the inquiry into whether "the directors are disinterested and independent,"[363] deals with the duty of loyalty, which is what one would expect of a "demand futility" argument. However, the second prong, the inquiry into whether "the challenged transaction was

---

358. *See supra* notes 303–05 and accompanying text.

359. *See* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004) ("[I]f an action is derivative, the plaintiffs are then required to comply with the requirements of Court of Chancery Rule 23.1, that the stockholder: (a) retain ownership of the shares throughout the litigation; (b) make presuit demand on the board; and (c) obtain court approval of any settlement. . . ."); *see also id.* ("The decision whether a suit is direct or derivative may be outcome-determinative.").

360. DEL. CH. CT. R. 23.1.

361. *See* Grimes v. Donald, 673 A.2d 1207, 1218–19 (Del. 1996).

> If a demand is made, the stockholder has spent one—but only one—"arrow" in the "quiver." The spent 'arrow' is the right to claim that demand is excused. The stockholder does not, by making demand, waive the right to claim that demand has been wrongfully refused. . . . If a demand is made and rejected, the board rejecting the demand is entitled to the presumption of the business judgment rule . . . .

Id.

362. 473 A.2d 805, 814 (Del. 1984); *see supra* note 78 and accompanying text.

363. *Aronson*, 473 A.2d at 814.

Washington University Open Scholarship

otherwise the product of a valid exercise of business judgment,"[364] extends to the duty of care. It provides that plaintiffs can establish demand futility by "alleg[ing] particularized facts creating a reasonable doubt that the actions of the defendants were protected by the business judgment rule."[365]

Because of the flexibility of the *Aronson* test, it makes sense for plaintiffs to raise all of their fiduciary duty claims under the mantle of demand futility rather than to make a demand. Although the "reasonable doubt" standard may not be very generous,[366] it surely is better than facing the business judgment rule directly. As a result, the requirement of particularized allegations affects almost all derivative litigation. Thus it is fair to say, as a general matter, that "pleadings [in derivative suits] must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings . . . ."[367] These stringent requirements are made more difficult by the fact that the plaintiff will not yet have the benefit of discovery.[368] The aggregate effect is a reduction in both the volume and expense of derivative litigation. The benefits of the particularized allegations requirement should apply to the proposed standard as well.[369]

However, the proposed standard would work some fairly significant changes in the way questions regarding derivative litigation would be handled. Delaware has an elaborate system in place in order to determine when the business judgment rule should apply.[370] Under the proposed standard, the business judgment rule never would apply because of structural bias. The question would always be one of substantive reasonableness. This would simplify matters significantly because a plaintiff's choice between making a demand and alleging demand futility

---

364. *Id.*

365. Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000).

366. *See supra* notes 271–86 and accompanying text.

367. *Eisner*, 746 A.2d at 254.

368. *See* Rales v. Blasband, 634 A.2d 927, 934 & n.10 (Del. 1993) ("derivative plaintiffs . . . are not entitled to discovery to assist their compliance with Rule 23.1"); *see also Eisner*, 746 A.2d at 254–55 (discussing the limited discovery rights of stockholders when making specific allegations under Rule 23.1).

369. As will be argued, all issues of demand will be reviewed for substantive reasonableness, such that there will not be a pressing need to argue demand futility. Thus, it might seem that a plaintiff could escape the requirement of particularized allegations by making a demand: particularized allegations would be required only for the demand issue and not the underlying merits. However, the court would be deciding whether the directors' response to the demand was reasonable. Without particularized allegations suggesting otherwise, the rejection of a shoddy demand will be difficult to characterize as unreasonable. *See infra* notes 370–83 and accompanying text.

370. *See* Grimes v. Donald, 673 A.2d 1207 (Del. 1996) (waiver of demand futility); Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (standards for demand futility); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (demand excused).

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

would not be so consequential. If shareholders were to make a demand, or the directors otherwise were to decide on whether to proceed with the derivative action, the directors' decision would be subject to review for substantive reasonableness. If the shareholder plaintiffs were to argue demand futility and the directors did not have the opportunity to make a decision on the matter, the plaintiffs would have to argue that a decision not to proceed with litigation would be unreasonable. Finally, if demand were excused or wrongfully refused and the board subsequently established a special litigation committee to dismiss the action, the decision of the committee also would be subject to review for substantive reasonableness.[371]

The proposed standard eliminates the need for both the *Zapata* and *Aronson* tests. *Zapata*'s reliance on the court's business judgment[372] would be replaced by the review for substantive reasonableness. *Aronson*'s two-part test would be unnecessary because plaintiffs would have the benefit of the intermediate standard of review:[373] they would never need to establish irrationality or waste (although they would be free to argue that the directors were, in fact, interested or not independent).[374] Moreover, *Aronson*'s "reasonable doubt" standard would be too awkward when combined with the "range of reasonableness" standard.[375] However, *Aronson*'s underlying interpretation of the particularized allegations requirement should stand. Thus, the *Aronson* framework could be replaced by a simpler one: that the plaintiff must allege particularized facts creating a strong inference of unreasonableness.[376]

The proposed standard also would have the benefit of encouraging shareholders to make a demand. Shareholders would not feel unable to do so because, even if they were to lose the ability to claim demand futility, they would retain the benefits of review for substantive reasonableness due to structural bias. In fact, under the proposed standard it should be easier to prevail after a demand has been refused than it would be in the

---

371. *But see infra* notes 378–80 and accompanying text.

372. *See supra* note 118 and accompanying text.

373. However, the proposed standard could be incorporated into the *Aronson* framework: plaintiffs would be permitted to make the typical arguments, challenging the directors' independence or business judgment, as well as a reasonableness argument.

374. *See supra* note 199 and accompanying text. In light of the availability of special litigation committees, it would be the rare case indeed where plaintiffs could make a showing sufficient to invoke the entire fairness test.

375. Although it would be quite awkward, *Aronson*'s "reasonable doubt" standard could be retained despite the adoption of the proposed standard: plaintiff would have to allege facts with particularity creating a reasonable doubt about whether the directors' decision was reasonable.

376. *Cf. supra* note 365 and accompanying text.

Washington University Open Scholarship

absence of a litigation decision by directors, as might be the case in a demand futility claim. To establish demand futility without a record, the plaintiffs would have to prove that a decision not to proceed would not—which is to say, *could* not—be reasonable; the courts would have to give directors the benefit of hypothetical reasoning.[377] However, once there is a record complete with directors' reasons, as always would be the case after a demand had been made, the plaintiffs would need to show only that the actual decision was unreasonable.

Moreover, directors would be handicapped in subsequently establishing a special litigation committee to dismiss the case. Once it has been established that it would be unreasonable not to pursue the case—whether because of demand futility or wrongful refusal—it would be difficult (although not impossible) to argue subsequently that the case should be dismissed.[378] In a court's review of such a decision, "some tribute must be paid to the fact that the lawsuit was properly initiated."[379] It would be especially difficult to justify a dismissal as reasonable "after years of vigorous litigation for reasons unconnected with the merits of the lawsuit."[380] To the extent that the proposed standard encourages demand or discourages wasteful efforts by special litigation committees,[381] it also would reduce the expenses incurred in litigating demand futility. Although litigation expenses might increase overall,[382] this would be another mitigating factor.[383]

A good example of a case that likely would have been decided differently under the proposed standard is the case of *Brehm v. Eisner*.[384] At first, the case may seem to be a poor candidate. The court described the complaint as "a pistache of prolix invective . . . permeated with conclusory allegations,"[385] that "does not comply with . . . fundamental pleading mandates" of particularized allegations.[386] This characterization was

377. *See infra* note 406.

378. This is because a derivative lawsuit would only be permitted to proceed—whether demand had been refused or considered futile—after a determination that not proceeding would be unreasonable. The special litigation committee's decision to dismiss the case would have to be based on new facts or arguments in order to be considered reasonable.

379. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

380. *Id.*

381. Not all efforts by special litigation committees to dismiss properly initiated derivative lawsuits would be wasteful. However, since the standard of review would be unchanged—i.e., substantive reasonableness—such efforts would be wasteful in many cases.

382. *See supra* notes 298–302 and accompanying text.

383. *See also supra* notes 303–06, 357–69 and accompanying text.

384. 746 A.2d 244 (Del. 2000).

385. *Id.* at 249.

386. *Id.* at 254.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

justified by the subsequent amended complaint, which presents a very different set of the facts.[387] However, despite the "inartfully drafted" complaint, the court was able to "ferret out" sufficient allegations to admit that "both as to the processes of the two boards and the waste test, this is a close case."[388] If the case was a close one under the business judgment rule, it seems fairly obvious that it could have been decided differently under an intermediate standard of review.

The *Eisner* court was willing to dismiss the case on the facts as alleged. Given the extreme nature of those facts, this is a troubling precedent. As it turns out, there was no harm done because the plaintiffs were able to do a little more legwork, discover a different set of facts, and produce a superior complaint. However, had the plaintiffs been unable to do so, either because of a lack of discovery or because the facts actually were as originally alleged, their meritorious claim would have been dismissed for the sake of judicial economy. This would have been unfortunate.

In essence, the original complaint alleged that the directors of The Walt Disney Company breached their fiduciary duties in approving an employment agreement with Michael S. Ovitz as president and in later granting him a "non-fault" termination of that agreement.[389] The structure of the employment agreement was criticized on the grounds that "the contract gave Ovitz an incentive to find a way to exit the Company via a non-fault termination as soon as possible because doing so would permit him to earn more than he could by fulfilling his contract."[390] The grant of a

---

387. *Compare id.* at 249–53 (facts as originally pleaded), *with In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 278–85 (Del. Ch. 2003) (facts as pleaded in amended complaint).

388. *Eisner*, 746 A.2d at 249.

> This is potentially a very troubling case on the merits. On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory. On the other hand, the Complaint is so inartfully drafted that it was properly dismissed under our pleading standards for derivative suits. From what we can ferret out of this deficient pleading, the processes of the Old Board and the New Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions. Therefore, both as to the processes of the two Boards and the waste test, this is a close case.

Id.

389. *See id.* at 248–49. In addition, the choice of Ovitz was criticized because of his lack of qualifications, *see id.* at 249 ("At the time, Ovitz was an important talent broker in Hollywood . . . . [H]e lacked experience managing a diversified public company."), and it was alleged that he was selected because of his long-standing friendship with the chairman and CEO, Michael Eisner. *See id.* These allegations were not well supported.

390. *Id.* at 251. The court summarized the terms of the employment agreement as follows:

Washington University Open Scholarship

non-fault termination was criticized on the grounds that it was wasteful[391] and that the company could have sought a termination for cause.[392] The facts were sufficiently egregious that even the basic allegations would have been sufficient to survive a motion to dismiss under the proposed standard.

The court defended the structure of the employment agreement on the ground that the directors were statutorily protected in relying on an expert.[393] This was so even though "'nobody'—not Crystal [the expert]

> Ovitz' Employment Agreement had an initial term of five years and required that Ovitz "devote his full time and best efforts exclusively to the Company," with exceptions for volunteer work, service on the board of another company, and managing his passive investments. In return, Disney agreed to give Ovitz a base salary of $1 million per year, a discretionary bonus, and two sets of stock options (the "A" options and the "B" options) that collectively would enable Ovitz to purchase 5 million shares of Disney common stock.
>
> The "A" options were scheduled to vest in three annual increments of 1 million shares each, beginning on September 30, 1998 (*i.e.*, at the end of the third full year of employment) and continuing for the following two years (through September 2000). The agreement specifically provided that the "A" options would vest immediately if Disney granted Ovitz a non-fault termination of the Employment Agreement. The "B" options, consisting of 2 million shares, differed in two important respects. Although scheduled to vest annually starting in September 2001 (*i.e.*, the year *after* the last "A" option would vest), the "B" options were conditioned on Ovitz and Disney first having agreed to extend his employment beyond the five-year term of the Employment Agreement. Furthermore, Ovitz would forfeit the right to qualify for the "B" options if his initial employment term of five years ended prematurely for any reason, even if from a non-fault termination.
>
> The Employment Agreement provided for three ways by which Ovitz' employment might end. He might serve his five years and Disney might decide against offering him a new contract. If so, Disney would owe Ovitz a $10 million termination payment. Before the end of the initial term, Disney could terminate Ovitz for "good cause" only if Ovitz committed gross negligence or malfeasance, or if Ovitz resigned voluntarily. Disney would owe Ovitz no additional compensation if it terminated him for "good cause." Termination without cause (non-fault termination) would entitle Ovitz to the present value of his remaining salary payments through September 30, 2000, a $10 million severance payment, an additional $7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first 3 million stock options (the "A" Options).

Id. at 250 (footnotes omitted).

391. The court agreed that "the non-fault termination left Ovitz with what essentially was a very lucrative severance agreement," but noted that "in the end the payout to Ovitz did not exceed the 1995 contractual benefits." *Id.* at 252.

392. *Id.* at 253 ("The allegation of waste is based on the inference most favorable to plaintiffs that Disney owed Ovitz nothing, either because he had resigned (*de facto*) or because he was unarguably subject to firing for cause.").

393. *See id.* at 261. Section 141(e) of the Delaware General Corporation Law provides as follows:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

and not the directors—[calculated 'the economic exposure of the corporation to the payout scenarios of the Ovitz contract'], although all the necessary information presumably was at hand to do so."[394] While this might be acceptable behavior under the business judgment rule,[395] it would not fall within the range of reasonableness.

Directors may be entitled to rely in good faith on "information, opinions, reports or statements"[396] of experts, but they should not be permitted to delegate the ultimate decision to experts. The directors, not the experts, are the ones who must exercise business judgment in deciding on such fundamental questions as the nature and amount of executive compensation.[397] Thus, they should not be protected in relying on experts without first coming to a rudimentary understanding of the agreement.

The employment agreement was not terribly complicated. Even a basic understanding would have revealed the problem described in the complaint. The contract provided that Ovitz would receive a salary of $1 million per year, plus discretionary bonuses and stock options. He also would receive a $10 million bonus if his contract were not renewed. However, if Ovitz were to obtain a non-fault termination, he would receive the $1 million per year salary payments, plus $7.5 million per year, as well as $10 million in severance pay, and most, but not all, of the options.[398] Even excluding the value of stock options, which could be tremendous but are inherently volatile,[399] the cash payments under the employment agreement totaled $15 million, plus discretionary bonuses, if Ovitz completed his term of employment, and approximately $52.5 million if Ovitz was granted a non-fault termination on the first day.[400] It would not take a qualified expert to appreciate the deficiencies of such an

DEL. CODE ANN. tit. 8, § 141(e) (2001). As the *Eisner* court pointed out, however, "[t]his protection . . . is not without limitation, as in a case of corporate waste." *Eisner*, 746 A.2d at 261 n.51.

394. *Eisner*, 746 A.2d at 260; *see id*. at 259.

395. *Id.* at 260–61.

396. DEL. CODE ANN. tit. 8, § 141(e) (2001).

397. DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

398. *See supra* note 390. Actually, he would receive only "the present value of his remaining salary payments," *Eisner*, 746 A.2d at 250, which would make the amount somewhat less than $1 million per year.

399. Most of the value of Ovitz's severance package came from the stock options. In fairness, the Chancery Court "concluded that the vesting schedule of the options actually was a disincentive for Ovitz to leave Disney," *Eisner*, 746 A.2d at 263, because Ovitz would be giving up a significant number of options. However, the mere possibility of obtaining such options would not necessarily make up for the certainty of reduced payments and five years of labor.

400. In addition, Ovitz would be able to pursue other employment or investment activities for five years. This is a significant benefit to an early termination.

Washington University Open Scholarship

arrangement. A decision to approve such a contract may or may not be rational, but it would not be reasonable.

The court defended the board's subsequent decision to grant a non-fault termination on the basis of the uncertainty and expense of litigating the issue of fault:

> All [that the Complaint] shows is that the Board had *arguable* grounds to fire Ovitz for cause. But what is alleged is only an *argument*—perhaps a good one—that Ovitz' conduct constituted gross negligence or malfeasance. First, given the facts as alleged, Disney would have had to persuade a trier of fact and law of this argument in any litigated dispute with Ovitz. Second, that process of persuasion could involve expensive litigation, distraction of executive time and company resources, lost opportunity costs, more bad publicity and an outcome that was uncertain at best and, at worst, could have resulted in damages against the Company.[401]

This type of argument is commonly used by boards of directors in refusing a demand and by special litigation committees in seeking dismissal.[402] It is therefore a very important issue in derivative litigation.

A cost/benefit analysis is an important consideration in the decision of whether to proceed with any lawsuit. Litigation is expensive and risky. A decision to sue entails more than just a determination of the merits of the claim:[403] even a risky case may be worth pursuing because of the potential reward, and even an easy case may not be worth pursuing because of the related expenses.[404] However, the claim that the costs outweigh the benefits is ubiquitous among directors deciding on whether to pursue derivative litigation. Surely the argument is valid in many cases, perhaps even in most cases. But it is implausible that it should be valid in nearly all

401. *Eisner*, 746 A.2d at 265.

402. *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 997 (N.Y. 1979) (The special litigation committee concluded "that if the action were allowed to proceed the time and talents of the corporation's senior management would be wasted on lengthy pretrial and trial proceedings, that litigation costs would be inordinately high in view of the unlikelihood of success, and that the continuing publicity could be damaging to the corporation's business.").

403. The court's suggestion that plaintiffs had to "set forth particularized facts that he resigned or unarguably breached his Employment Agreement," *Eisner*, 746 A.2d at 264, was a bit simplistic. Lawsuits may be worth pursuing even if the outcome is not perfectly clear.

404. Ultimately, it boils down to a very sophisticated calculation of expected values. A simplistic example follows. Assume two lawsuits have similar litigation-related expenses of $1 million each. The first lawsuit offers a 10% chance of a $20 million verdict, while the second lawsuit offers a 99% chance of a $1 million payout. The first case would be worth pursuing because it has an expected value of $1 million ($20 million × 10% - $1 million), while the second would not be worth pursuing because it has a slightly negative expected value ($1 million × 99% - $1 million).

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

cases.[405] Although litigation is expensive, the potential award in many cases is quite large.

The cost/benefit argument is legitimate as to form. As to the merits, it is the type of decision that courts would normally leave to the business judgment of directors. However, because of structural bias, that would be inappropriate. On matters of derivative litigation, courts cannot defer to directors' expertise. Rather, they must consider the merits of the competing arguments to decide whether the directors' decision was unreasonable. In many cases, the directors' decision will be the obviously correct one; in some cases, the decision will be a difficult one, but not unreasonable. Sometimes, however, it will be objectively unreasonable not to pursue a claim.

Whether a given decision is reasonable may depend on the reasons given.[406] When the potential award is sufficiently great, a casual claim or conclusory assertion by the directors should not be sufficient to carry the day. A more serious analysis would allow the court to evaluate the decision on the merits—not to decide whether it was correct, but only to decide whether it was unreasonable. If the directors' analysis is realistic, their decision is likely to be upheld as reasonable.[407] On the other hand, if their decision is based on unrealistic assumptions, it could lead the court to conclude that the decision was unreasonable.[408]

In *Eisner*, over $140 million was at stake. As long as the case was not frivolous—and it was clear that the court thought it had some merit[409]—it would be difficult to believe that the case should be dismissed on cost/benefit grounds. Although such a decision might be upheld under the business judgment rule, it should not be upheld under the proposed standard—at least not without sufficient justification.[410]

---

405. If the courts believe that the costs of derivative litigation outweigh the benefits, they should consider eliminating the derivative action altogether.

406. In theory, the court may have to engage in a hypothetical analysis in cases alleging demand futility because no decision will have been made. *See supra* text accompanying note 377. In practice, directors likely would be permitted to present an analysis to the court.

407. Nevertheless, it is possible that conflicted directors could come to an objectively unreasonable decision. *See supra* note 249 and accompanying text.

408. As a simplistic example, directors may conclude that a lawsuit is not worthwhile based on the assumptions of a 10% chance of success, a $10 million dollar award, and $2 million in attorneys fees (expected value: -$1 million). However, if the court were to believe that the chance of success were more like 50%, the likely award closer to $20 million, and the likely attorneys fees only $1 million (expected value: $9 million), it could conclude that the directors' decision was objectively unreasonable.

409. The court considered the argument to be "perhaps a good one." Brehm v. Eisner, 746 A.2d 244, 265 (Del. 2000). Overall, the court considered the complaint to present "a close case." *Id.* at 249.

410. When the stakes are high enough, it is not reasonable to assume that the costs of litigation

Washington University Open Scholarship

Thus, review for substantive reasonableness could have made a difference in the *Eisner* case, both on the issue of the initial approval of the employment agreement and on the subsequent grant of a non-fault termination. The Delaware Supreme Court was uncomfortable with its decision but felt compelled because of the deference of the business judgment rule.[411] The proposed standard would have permitted the court to come to a more reasonable conclusion.

C. Executive Compensation

If the shareholder-plaintiffs make it past the procedural hurdles of derivative litigation, they will have the opportunity to challenge the substantive merit of the directors' decisions. This section will consider how review for substantive reasonableness might operate in an important and controversial setting: executive compensation decisions. It will attempt to apply the proposed standard in three notorious cases. This should help to illustrate the impact of a review for substantive reasonableness.

First, however, it must be asked why the business judgment rule would not apply to executive compensation decisions in the face of state laws such as section 144(a) of the Delaware General Corporation Law.[412] That statute provides as follows:

> (a) No contract or transaction between a corporation and 1 [one] or more of its directors or officers . . . shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because of any such director's or officer's votes are counted for such purpose, if:
>
> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the

outweigh the benefits, so directors should have to justify such a conclusion. In fairness, *Eisner* was a demand futility case. Thus, even if the proposed standard had been applied, the court may not have had the benefit of the directors' analysis and may have resorted to hypothetical reasoning to decide whether a decision not to pursue the case could be reasonable. *See supra* text accompanying note 377. However, even hypothetical reasoning has its limits. A $140 million claim is a difficult hurdle to overcome.

411. *See Eisner*, 746 A.2d at 249.

412. DEL. CODE ANN. tit. 8, § 144 (2001).

affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.[413]

Executive compensation decisions would seem to fall within the protection of such statutes. Thus, justification must be given for subjecting such decisions to an intermediate standard of review.

One possible reason would be to argue that, because of structural bias, no directors should qualify as "disinterested directors." Although there is some truth in the claim, it is the type of argument that would be better directed in support of an amendment of the statute rather than an eviscerating interpretation of it.

More promising is the statutory language itself. The Delaware Supreme Court has interpreted section 144 as "merely remov[ing] an 'interested director' cloud . . . and provid[ing] against invalidation of an agreement 'solely' because such a director or officer is involved," but not as "sanction[ing] unfairness . . . or remov[ing] the transaction from judicial scrutiny."[414] Thus, such contracts and transactions are not immune from review, but generally are given the protection of the business judgment rule.[415] However, the decision to apply the business judgment rule instead of the entire fairness test or an intermediate standard of review is a deliberate one by the courts, not one that necessarily was required by statute.[416] Moreover, even when the business judgment rule is applied, the contract or transaction is considered voidable if the plaintiff can establish either gross negligence or waste.[417] In light of structural bias, the standard

413. *Id.*

414. Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976).

415. *See supra* note 74 and accompanying text.

416. *See, e.g.*, *Fliegler*, 361 A.2d at 221 (applying entire fairness test despite statutory language in case in case involving shareholder approval). *See generally* GEVURTZ, *supra* note 14, at 337–41.

417. *See* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors . . . or disinterested stockholders . . . permits the invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.").

Washington University Open Scholarship

should be changed to unreasonableness. Thus, the contract or transaction in question would not be voidable *solely* because of the conflict, but because, in addition, the plaintiff has established that the contract or transaction was unreasonable.[418]

The first notorious example of executive compensation deals with the post-retirement benefits that were to be received by Jack Welch, former Chairman and CEO of General Electric Co. By all accounts, Mr. Welch was an exceptional manager.[419] Under his leadership, the company flourished.[420] His compensation packages were large—salary and bonus of over $16 million in 2000 and 2001, in addition to millions of stock options and other benefits[421]—but few were heard to complain. That is, until the details of his post-employment benefits were exposed in his divorce proceedings.[422] In addition to a lucrative consulting arrangement, Mr. Welch was to receive, "for the remainder of his life, continued access to Company facilities and services comparable to those provided to him prior to his retirement, including access to Company aircraft, cars, office, apartments, and financial planning services."[423] The aggregate value of these benefits was over $2 million per year.[424] The resulting outrage was severe, and Mr. Welch's previously golden reputation suffered significantly.[425]

---

418. In any event, even if an unreasonable executive compensation agreement were not voidable, the directors could still be liable for breach of fiduciary duty in approving such an agreement. In a derivative action against the directors, the proposed standard would apply. Thus, it remains important to consider the application of the proposed standard to executive compensation decisions.

419. *See* Jeffrey E. Garten, *Jack Welch: A Role Model for Today's CEO?*, BUS. WK., Sept. 10, 2001, at 32 ("Already [Jack Welch] has been hailed as one of the great business leaders of the past half-century—and deservedly so."); *Jack Welch: A CEO Who Can't Be Cloned*, BUS. WK., Sept. 17, 2001, at 130 ("It is a testament to the success of the man that no other business manager anywhere rivals him in terms of peer respect.").

420. *See* Garten, *supra* note 419, at 32 ("From 1982 through 2000, GE's average annual total return to shareholders was 25%, compared with 17% for the Standard & Poor's 500-stock index."); CNN/Money, *SEC Probes Welch Deal* (Sept. 16, 2002), *available at* http://money.cnn.com/2002/09/16/news/companies/welch_wsj/ ("GE's market capitalization stood at $402.4 billion when Welch retired a year ago, about a 5,000 percent increase in the stock's value, including dividends, while he was at the helm.").

421. *See* GENERAL ELECTRIC CO. PROXY STATEMENT 20–21 (2002).

422. Although the details were fleshed out in his wife's divorce filings, the terms of Welch's retention agreement were made public shortly after the agreement was executed. *See* Employment and Post-Retirement Consulting Agreement, Dec. 20, 1996, *in* GENERAL ELECTRIC CO. ANNUAL REPORT ON FORM 10-K, Exhibit 10(w) (1996) [hereinafter Welch Agreement].

423. *See* Welch Agreement, *supra* note 422, at ¶ 5.

424. *See* Jack Welch, *My Dilemma—And How I Resolved It*, WALL ST. J., Sept. 16, 2002, at A14 ("I will pay the costs for my use of all other facilities and services provided by GE such as planes and the company apartment. I estimate that I will be paying between $2 million and $2.5 million a year for these services.").

425. *See* Anthony Bianco, *The Fall of an Icon*, BUS. WK., Sept. 23, 2002, at 46 ("After a year of

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

In fact, however, Welch's post-retirement benefits easily would withstand scrutiny under the proposed standard. Although $2 million a year may seem like a great deal of money to the author or to the average reader, it is not particularly great by comparison to Mr. Welch's overall compensation; his pension alone entitles him to over $7 million annually.[426] Thus, if the remainder of his compensation were reasonable—a characterization that few have bothered to challenge—then it would be difficult to hold the incremental post-retirement benefits unreasonable.

The reasonableness of Mr. Welch's post-retirement benefits becomes clearer when the circumstances of the award are considered. They were not a gift bestowed upon Mr. Welch on his retirement for a job well done. Such an award arguably would be a waste of corporate assets.[427] Rather, Mr. Welch's benefits were negotiated as part of a retention agreement. Mr. Welch was approaching retirement age when he suffered a heart attack and underwent quintuple bypass surgery.[428] The board wanted to ensure that he would remain with the company long enough to groom a successor. According to Mr. Welch, the board offered him $100 million; he turned the offer down and requested a package of benefits that almost certainly would be worth significantly less.[429] The real issue, then, is whether such a large retention bonus would have been reasonable. In his rare case, it probably would have been.[430] If so, it should not matter that he preferred to take the bonus in kind over the course of his retirement rather than in cash or stock immediately.

The second notorious example is the compensation received by Richard Grasso, former Chairman and CEO of the New York Stock Exchange. Although the New York Stock Exchange is a not-for-profit

---

unrelenting corporate scandal, tolerance of CEO self-aggrandizement is so low that even Welch, once crowned the 'Manager of the Century,' has become a target of resentment and revisionism.").

426. *See* Plaintiff's Financial Affidavit at 1, John F. Welch, Jr. v. Jane B. Welch, at 1 (Conn. Super. Ct. 2002) ("Gross Monthly Pension: $618,687").

427. *See, e.g.*, Adams v. Smith, 153 So. 2d 221, 226 (Ala. 1963) (holding decision to pay pension to widows of recently-deceased officers *ultra vires* for lack of consideration).

428. JOHN F. WELCH, JR., JACK: STRAIGHT FROM THE GUT 325–28 (John A. Byrne ed., 2001).

429. *See Life After GE? And How*, BUS. WK., Mar. 8, 2004, at 76 ("The board came to me . . . and they said: 'We'd like to give you $100 million in restricted stock to stay 'til you're 65 and make the succession work.' I said: 'I don't need $100 million. I'm too cheap to spend it anyway . . . . But what I would like to do is keep the plane and the apartment, which cost about $1.7 million a year."); Welch, *supra* note 424, at A14 ("[T]he board . . . suggested an employment contract, which offered me a special one-time payment of tens of millions of dollars to remain as CEO until . . . [age] 65. I instead agreed to take the post-retirement benefits . . . instead of cash compensation . . . that would have been much more expensive for the company.").

430. *Cf. infra* note 456 and accompanying text.

Washington University Open Scholarship

entity rather than as a business corporation,[431] the following discussion nevertheless will apply the proposed standard as if the same principles applied. Like Mr. Welch, Mr. Grasso undeniably was an exceptional manager.[432] Under his leadership, the New York Stock Exchange flourished[433] at a time when it might have been expected to whither away in the face of increasing competition from more modern rivals.[434] Problems for Mr. Grasso began when it was announced that, in connection with the extension of his employment contract, he would be receiving a cash payment in an amount of $139.5 million.[435]

Of course, Mr. Grasso had not received an annual salary of $139.5 million; nor was that amount a retention bonus. It was an aggregate amount that represented his earnings over a number of years pursuant to complicated benefit plans and deferral programs.[436] His salary had been capped at $1.4 million for a number of years.[437] However, his incentive compensation and capital accumulation plan awards were significantly greater—as high as $16 million and $8 million, respectively, in 2001.[438] The appropriate question, then, is not whether a $140 million payout was reasonable, but rather whether an aggregate annual compensation in the

---

431. *See infra* note 441 and accompanying text.

432. *See* Gary Weiss, *The $140,000,000 Man: What Dick Grasso's Excessive Payout Reveals About How He Runs the New York Stock Exchange*, BUS. WK., Sept. 15, 2003, at 84, 86 ("Grasso is an undeniably talented manager. . . . Even his sharpest critics agree that Grasso has almost single-handedly built up the exchange's public image—which, along with an intense detail-oriented approach, has helped maintain the NYSE's superb market-share numbers.").

433. *See id.* at 84–87. "Grasso's allies credit him with . . . maintaining a prosperous exchange, with 1,549 of its 2,800 companies joining on his watch, and a consistent 80% market share of the trading of NYSE stocks." *Id.* at 87. "In addition, seat prices have tripled in price since he became chairman in 1994." *Id.* at 86.

434. *See* Holman W. Jenkins Jr., *Who Decides How Much is Too Much?*, WALL ST. J., Sept. 24, 2003, at A21 ("Mr. Grasso's tenure happened to coincide with a universal panic that the NYSE franchise, funnel for $9 trillion a year in trading volume, was in danger of slipping away.").

435. *See* Kate Kelly, *NYSE Chief Will Collect $139.5 Million*, WALL ST. J., Aug. 28, 2003, at C1. It also was announced that he would be entitled to receive an additional $48 million over the course of the next few years. *See* Kate Kelly, *Grasso Takes More Heat on Pay*, WALL ST. J., Apr. 20, 2004, at C1.

436. *See* Kelly, NYSE Chief, *supra* note 435, at C1.

> [Mr. Grasso] is withdrawing $139.5 million in savings he has acquired during his career of more than three decades at the NYSE. That payout is a combination of $40 million in a savings account, a previously accrued retirement benefit of $51.6 million, and a previously earned balance of $47.9 million that is the result of prior incentive awards.

Id.

437. *See* Carol J. Loumis, *Dick Grasso's Pay: The Sequel*, FORTUNE, Feb. 9, 2004, at 22, 24.

438. Letter from Carl McCall to William H. Donaldson, Chairman, U.S. Securities and Exchange Commission 7 (Sept. 9, 2003), *available at* http://www.nyse.com/pdfs/donaldsonletter.pdf [hereinafter McCall Letter].

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

eight-figure range (over $30 million in 2001 alone![439]), together with other benefits,[440] was reasonable.

If the New York Stock Exchange were a typical business, it likely would have been reasonable for the board to pay Mr. Grasso such large amounts. After all, Mr. Grasso's leadership was extraordinary. However, there are a number of factors that complicate the analysis.

In the first place, the New York Stock Exchange is not a typical business. In fact, it is a not-for-profit corporation. Under the New York Not-for-Profit Corporation Law, an officer's compensation must be "reasonable" and "commensurate with [the] services performed."[441] Whether the management of a not-for-profit organization should receive compensation that equals or even exceeds the private market is a difficult question. New York Attorney General Eliot Spitzer believes that it should not, and has sued Mr. Grasso for reimbursement on behalf of the New York Stock Exchange.[442] If, however, the New York Stock Exchange's desire to "attract and retain superior 'world class' executives"[443] is reasonable, then the payment of competitive compensation should also be considered reasonable. And if Mr. Grasso's performance were exceptional, it should not be surprising that his compensation also would be exceptional.

However, an additional complicating factor is the fact that the New York Stock Exchange also is a self-regulatory organization under the federal securities laws.[444] That made Mr. Grasso a regulator. His compensation was not only far greater than that of public regulators, such as the Chairman of the SEC,[445] but also far greater than other private regulators,[446] such as the heads of the Public Company Accounting

---

439. *See id.* (total compensation of $25,550,000 plus "Special Payment" of $5,000,000).

440. For example, Mr. Grasso was also entitled to participate in various retirement plans that were also quite generous. *See id.* at 5–7; *see also* Shawn Tully, *See Dick Squirm*, FORTUNE, Sept. 29, 2003, at 77, 80 ("In 2001 . . . Grasso made some $30 million in salary, bonus, and long-term comp, *not including a hefty contribution to his retirement account*.") (emphasis added).

441. N.Y. NOT-FOR-PROFIT CORP. LAW § 202(a)(12) (McKinney 1997).

442. *See* Kate Kelly & Susanne Craig, *Spitzer Files Suit Seeking Millions of Grasso Money*, WALL ST. J., May 25, 2004, at A1.

443. *See* McCall Letter, *supra* note 438, at 2.

444. *See* Securities Exchange Act of 1934 § 6, 15 U.S.C. § 78f (2000).

445. "Mr. Donaldson receives a salary of $142,500 as S.E.C. Chairman, and no bonus." Landon Thomas Jr., *S.E.C. Chairman Wants Details of Compensation Paid to Grasso*, N.Y. TIMES, Sept. 3, 2003, at C1.

446. Although most quasi-regulators have not received nearly as much as Mr. Grasso, there is at least one exception:

> By the standards of the New York Stock Exchange, James J. McNulty, the president and chief executive of the Chicago Mercantile Exchange, does not have an outsized salary. It was slightly less than $1.9 million last year.

Washington University Open Scholarship

Oversight Board[447] or the National Association of Securities Dealers.[448] For Mr. Grasso to be paid so much more than other regulators is more than just unseemly; it raises serious questions about whether he might be tempted to ignore his regulatory duties in favor of business matters. After all, the business of regulation is not a profit center that would justify increased compensation. In light of the special nature of the New York Stock Exchange, Mr. Grasso's compensation arguably should be deemed unreasonable.

Finally, the most disturbing factors are those alleged by Mr. Spitzer in his complaint. Mr. Spitzer claims that Mr. Grasso's employment agreements were "the product of a process that permitted Grasso improperly to influence both the amounts awarded to him and the members of the New York Stock Exchange Compensation Committee and Board of Directors who were required to approve those awards."[449] If this heightened structural bias concern can be shown to have undermined the independence of the directors, then the entire fairness test should apply.[450] Even if not, however, the circumstances should be factored into the determination of reasonableness.[451] Mr. Spitzer also alleges that the agreements were "approved by the NYSE Board of Directors based upon

> But when his stock options are added, his total potential compensation is many times larger.
>
> At yesterday's closing price of $70.25, his exercisable options on the shares of Chicago Mercantile Exchange Holdings, which recently went public, were worth $69 million. Add the options he holds that cannot be exercised yet and the total value climbs to $86 million.

Jonathan Fuerbringer, *As More Markets Go Public, Salaries Are Under Scrutiny*, N.Y. TIMES, Sept. 24, 2003, at C1.

447. "Mr. McDonough will be paid handsomely in his new post, earning an annual salary of $556,000. That may be modest compared with the pay packages of many top accounting executives, but it's one of Washington's biggest salaries." Deborah Solomon & Cassell Bryan-Low, *'Tough' Cop for Accounting Beat*, WALL ST. J., Apr. 16, 2003, at C1.

448. *See* Jonathan Fuerbringer, *NASD Filing Discloses Salary and Bonus of Chief*, N.Y. TIMES, Sept. 25, 2003, at C7 ("Robert Glauber, the chairman and chief executive of NASD, was paid a salary and bonus totaling $2.1 million in 2002 . . . . In addition, Mr. Glauber received a payment award toward his executive retirement fund of $6.67 million. He also had deferred compensation of $283,663 and expenses and other allowances totaling $375,669."); *see also* Peter A. McKay, *Deals & Deal Makers NYSE: Rivals Disclose Their Top Officers' Pay*, WALL ST. J., Oct. 3, 2003, at C5 (reporting that Salvatore Sodano, Chairman and CEO of the American Stock Exchange, received "$5 million, including salary, bonus, pension, other benefits and deferred compensation" in 2002).

449. Complaint at 1, Spitzer v. Grasso (N.Y. Sup. Ct. 2004), *available at* http://news.findlaw.com/wp/docs/nys/nygrasso52404cmp.pdf (last visited Mar. 2005); *see* Kelly & Craig, *supra* note 442, at A1 ("The complaint accuses Mr. Grasso . . . of leaving some board members with the impression that if they opposed his pay packages, it would be at their peril. . . . It also alleges that Mr. Grasso took actions that benefited firms run by executives determining his compensation . . . .").

450. *See supra* note 199 and accompanying text.

451. *See supra* notes 253–55 and accompanying text.

materially incomplete, inaccurate and misleading information."[452] Disclosure to the board for decision-making purposes is a very serious matter. If the facts are as alleged by Mr. Spitzer,[453] then Mr. Grasso's compensation must be deemed unreasonable.

The third notorious example is one with which the reader is already familiar: Michael Ovitz's termination payment from The Walt Disney Company. Unlike Mr. Welch and Mr. Grasso, Mr. Ovitz did not prove to be an exceptional manager for Disney. However, he did receive a similar compensation package. The structure of Mr. Ovitz's compensation package and the circumstances of his award of a non-fault termination already have been discussed at length.[454] In the author's view, they should be sufficient to support a holding of unreasonableness.

An additional basis for a holding of unreasonableness, however, would be the sheer size of the termination payment under the circumstances. Mr. Ovitz was awarded $140 million after fourteen months of lackluster service.[455] Although the size of Mr. Ovitz's termination payment was similar to that of Mr. Welch's retention bonus offer, the two payments could not be more different: such a large payment may be justified to retain an exceptional manager, but not to remove an inferior one.[456] Courts may be tempted to give directors the benefit of the doubt under the business judgment rule, but there is not much doubt when the termination payment is so large. Moreover, such deference to the directors' business judgment on compensation matters is not warranted because of structural bias. The question under the proposed standard is whether the termination payment falls within the range of reasonableness. The answer is that it clearly does not.

The circumstances surrounding the ultimate decision do not change the result. The directors entered into an agreement that allowed for the possibility of such an unreasonable payment[457] and then voluntarily agreed

452. *See* Complaint at 1, Spitzer v. Grasso (N.Y. Sup. Ct. 2004), *available at* http://news.findlaw.com/up/docs/nys/nygrasso52404cmp.pdf (last visited Mar. 2005).

453. The author finds it difficult to believe that the board of directors was misled, and the claim has been forcefully denied by Ken Langone, former chairman of the NYSE compensation committee and co-defendant in the lawsuit. *See* Ken Langone, *Let's Bring on the Jury, Mr. Spitzer*, WALL ST. J., June 10, 2004, at A12 ("It is absurd to suggest that the brightest minds and keenest thinkers on Wall Street were befuddled by the complexity of Richard Grasso's compensation package—especially one composed just like their own.").

454. *See supra* notes 384–410.

455. *See* Brehm v. Eisner, 746 A.2d 244, 252–53 (Del. 2000).

456. *See supra* note 430 and accompanying text.

457. *See supra* note 390 and accompanying text.

Washington University Open Scholarship

to a non-fault termination.[458] While it may be possible that a good employment contract would lead to an unforeseeably large and unfortunate payment, this was not such a case. The result was entirely foreseeable. Directors cannot be permitted to justify such an unreasonable termination payment decision by reference to previous poor compensation decisions.

A comparison of the three examples illustrates how the three standards of review diverge. Welch's post-termination benefits surely would survive under either the business judgment rule or a review for substantive reasonableness; in fact, they probably even would survive under the entire fairness test, given his value to the company. Grasso's compensation may not be entirely fair, but surely would be considered rational. Whether it should be considered reasonable is a more difficult question, but given the special circumstances of the New York Stock Exchange, it arguably should not. Ovitz's termination payment is an easier case. Clearly it could not be considered entirely fair; it also should not be deemed reasonable. Even the Delaware Supreme Court concluded that it barely survived under the business judgment rule.[459]

Of course, a review for substantive reasonableness will not be a complete solution to the problem of excessive executive compensation. Because the proposed standard allows directors considerable discretion, it would not be suited for a direct challenge to compensation levels across the board. However, it would enable more aggressive enforcement against the outliers. This, in turn, could serve an important systemic function. At the very least, it should cause directors to hesitate before embarking on an overly-generous path. Increased accountability should serve to slow down the rate of increase in executive compensation, as well: directors likely would be less willing to engage in ratcheting behavior if they face the threat of meaningful review than they would if they knew that almost any compensation package would be protected by the business judgment rule. Moreover, when an extreme compensation package is challenged, the process employed to approve it is likely to be criticized. Because the process tends to be similar across companies, this may force all boards to reconsider their practices and significant change may result.[460] Thus, the impact of catching a few additional cases of abuse should not be underestimated.

---

458. *See supra* notes 389–392 and accompanying text.
459. *See supra* note 388 and accompanying text.
460. *See generally* BEBCHUK & FRIED, *supra* note 149.

D. Director Exculpation Statutes

One final issue that ought to be addressed is whether charter provisions that limit or eliminate liability for breach of fiduciary duty should apply in situations involving structural bias.[461] The answer to that question depends on whether structural bias is considered a duty of care issue or a duty of loyalty issue. As either a practical or a doctrinal matter, there is no easy answer.

"[S]tarting in late 1984 the market for directors' and officers' (D&O) liability insurance changed dramatically: premiums skyrocketed, deductibles increased, and coverage was reduced. There are reports of directors resigning because their firms had lost insurance coverage and of individuals declining invitations to serve on boards in increasing numbers."[462] In response to the crisis, many states adopted "director exculpation statute[s],"[463] which serve to limit director liability for breach of fiduciary duties. Section 102(b)(7) of the Delaware General Corporation Law is a typical example; it provides that a company's certificate of incorporation may contain:

> 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 § 174 of this title [unlawful distributions]; or (iv) for any transaction from which the director derived an improper personal benefit. . . .[464]

---

461. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *cf.* MODEL BUS. CORP. ACT § 2.02(b)(4) (2002).

462. Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 1–2 (1989) (footnotes omitted).

463. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1219 (Del. 1999).

464. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). The Model Business Corporation Act has a similar provision:

> [The articles of incorporation may set forth] . . . a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33 [unlawful distributions]; or (D) an intentional violation of criminal law . . . .

MODEL BUS. CORP. ACT § 2.02(b)(4) (2002).

Washington University Open Scholarship

The general effect of such laws is to allow corporations to limit or eliminate the liability of directors for breach of the duty of care, but not for breach of the duty of loyalty.[465] Thus, director liability for breach of fiduciary duty in cases involving structural bias depends on the characterization of that breach.

It may seem obvious that structural bias is a duty of loyalty issue. After all, the problem is one of conflicts of interest. However, the issue is not so simple. In cases involving structural bias, the business judgment rule is replaced by an intermediate standard of review because confidence in directors' judgment is compromised by conflicts of interest.[466] There is no proven breach of the duty of loyalty; if there were, the entire fairness test would apply.[467] Thus, although structural bias may seem to involve the duty of loyalty, it does not necessarily involve a *breach* of the duty of loyalty.

As previously discussed, the existing understanding of the duty of loyalty is fairly narrow.[468] When state legislatures enacted the statutory provisions, they presumably intended to exclude only what was understood to be covered—e.g., self-dealing. Establishing the unreasonableness of a board decision in a structural bias situation does not amount to a proven breach of the duty of loyalty.[469] Thus, structural bias cases should not be excluded from the scope of the statutory protection.

It may seem odd to consider unreasonable action a breach of the duty of care. However, as a technical matter, the designation does not matter. Liability for breach of fiduciary duty may be limited unless it is a breach of the duty of loyalty.[470] Thus, whether it is called a duty of care issue or some other fiduciary duty—perhaps a duty of reasonableness—the result is the same: liability may be limited.

As a policy matter, the question is whether shareholders ought to be able to relieve directors of personal liability for unreasonable decisions in situations involving structural bias. There is little reason to believe that

465. *See, e.g.*, S. 533, 133d Gen. Assembly 2, 65 Del. Laws ch. 289, §§ 1–2 (1986), *reprinted in* 1 FOLK, *supra* note 152, § 102.15, at GCL-I-27 n.56; *cf.* MODEL BUS. CORP. ACT § 2.02 cmt. 2.i., at 2–10 (2002) ("[t]erms such as 'duty of loyalty,' [and] 'good faith,'" rejected as imprecise).

Such laws also generally forbid limitation of liability for breach of the duty of good faith. The significance of the duty of good faith as a separate doctrine is unclear. *See supra* note 2.

466. *See supra* notes 239–41 and accompanying text.

467. *See supra* notes 196–99 and accompanying text.

468. *See supra* notes 139–44 and accompanying text; *see also supra* notes 200–16 and accompanying text.

469. A finding of unreasonableness does not imply a breach of the duty of good faith, either.

470. Of course, liability also may not be limited in the other circumstances listed, including breach of the duty of good faith. *See supra* note 464 and accompanying text.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

they should not. As previously discussed, situations involving structural bias demand the business judgment of directors.[471] Such business judgment can be faulty.[472] "[S]hareholders should be permitted—except when important societal values are at stake—to decide how to allocate the economic risk of the directors' conduct between the corporation and the directors."[473] While disloyal actions or actions taken in bad faith may rise to the level of seriousness that would make even voluntary exculpation inappropriate, structural bias—without more—does not.

If charter provisions allow directors to escape personal liability despite structural bias, one may wonder about the value of an intermediate standard of review that may serve to increase litigation costs without providing any shareholder benefit. There are at least two responses to this concern. First, not all directors will be relieved of liability. In many states, including Delaware, director exculpation provisions are optional: only directors of companies whose shareholders have adopted a charter provision eliminating their liability will be fully protected.[474] Thus, in many cases, directors will face personal liability.

Second, and more importantly, a finding of breach of fiduciary duty also would open the door to appropriate equitable relief. This is because the statutory provisions "do[] not operate to defeat the validity of a plaintiff's claim on the merits, [but only] to defeat the plaintiff's ability to recover monetary damages."[475] They "have no effect on the availability of equitable remedies, such as injunction or rescission."[476] Thus, in most cases, the improper conduct can be prevented or undone.[477]

In addition, there are other benefits to a finding of a breach of fiduciary duty under the proposed standard. For example, there is a powerful

471. *See supra* Part IV.A.2.

472. *But see In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968 (Del. Ch. 1996) ("If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors.").

473. MODEL BUS. CORP. ACT § 2.02 cmt. 2.i., at 2–9 (2002).

474. *See supra* note 464 and accompanying text.

475. Emerald Partners v. Berlin, 787 A.2d 85, 92 (Del. 2001).

476. S. 533, 133d Gen. Assembly 2, 65 Del. Laws ch. 289, §§ 1–2 (1986), *reprinted in* 1 FOLK, *supra* note 152, § 102.15, at GCL-I-27 n.56; *see also* MODEL BUS. CORP. ACT § 2.02 cmt. 2.i., at 2–9 (2002) (Section 2.02(b)(4) "follows the path of virtually all the states that have adopted charter option statutes and is applicable only to money damages and not to equitable relief.").

477. In many cases, the typical equitable remedies of injunction and rescission should be sufficient to prevent or undo the harm resulting from the breach of fiduciary duty. An aggressive remedy that might be helpful in other cases would be to find an unreasonable contract to be invalid and unenforceable, even as against non-fiduciaries. *See, e.g.*, Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 50–51 (Del. 1994).

Washington University Open Scholarship

expressive effect.[478] Under the business judgment rule, courts are limited in their ability to develop the standard of conduct under the duty of care. Because the standards of review are mere rationality and gross negligence, courts spend far more time justifying shoddy behavior than demanding excellence.[479] With an enhanced standard of reasonableness, the law may be developed in a more meaningful way. Directors will have a better understanding of what the law expects of them. Even without the fear of personal liability, directors' conduct should improve because of their desire to avoid the embarrassment of a judicial pronouncement of their unreasonableness.[480]

In short, personal liability for directors is only one of many practical reasons to support an intermediate standard of review. Even the elimination of such liability would not render judicial review meaningless. Thus, it should not undermine the purpose of an intermediate standard of review to consider structural bias a duty of care issue rather than a duty of loyalty issue, and to permit corporations to limit or even eliminate the liability of directors for unreasonable decisions.

CONCLUSION

Structural bias presents a challenge to corporate law. On the one hand, the deference of the business judgment rule is inappropriate because of directors' conflicting interests; on the other hand, the rigor of the entire fairness test is inappropriate because of the lack of evidence of self-dealing. An intermediate standard of review that could bridge the gap between these two doctrines is necessary. A moderate review of the substantive merits of directors' decisions is the solution.

The standard proposed in this Article—review for substantive reasonableness—is both practical and intellectually satisfying. It draws on the insights of the twin pillars of enforcement of fiduciary duties in corporate law while overcoming their respective weaknesses. Although the proposed standard may lead to an increase in litigation expense, the effect

---

478. For discussions of the expressive effect of law, see generally Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. PA. L. REV. 2181 (1996); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997); and Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

479. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000) ("[T]he law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices.").

480. Moreover, once certain behavior is deemed unreasonable, similar behavior in the future may be deemed a breach of the duty of good faith. If so, directors would not be shielded from personal liability.

https://openscholarship.wustl.edu/law_lawreview/vol82/iss3/4

should not be nearly as dramatic as might be feared. The return on the investment is a better balance between the competing values of directorial authority and accountability.

Nothing in this Article is intended to undermine either the business judgment rule or the entire fairness test. Both doctrines are sensible and well-suited for their primary function. However, neither is adequate for dealing with structural bias. In proposing and defending an intermediate standard of review, the author has sought to deal with subtle and complicated issues of conflicted interests while preserving the essential role of the two core doctrines of corporate law.

Washington University Open Scholarship