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Cover Page Footnote
This Article is based on the Robert E. Levine Distinguished Lecture which I gave at Fordham Law School in 1993. I thank Joe Hinsey, Meir Dan-Cohen, and a number of my colleagues who attended a colloquium at which I presented an earlier version of this Article, for their valuable comments.

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THE DIVERGENCE OF STANDARDS OF CONDUCT AND STANDARDS OF REVIEW IN CORPORATE LAW

MELVIN ARON EISENBERG*

In this Article, Professor Eisenberg examines how and why standards of conduct and standards of review diverge in corporate law. Professor Eisenberg analyzes the relevant standards of conduct and review that apply in a number of corporate law contexts. He discusses the reasoning and policies underlying these diverging standards. Professor Eisenberg explains the basis of most existing standards of conduct and review and suggests modifications of several others.

INTRODUCTION

This Article concerns standards of conduct and standards of review in corporate law. A standard of conduct states how an actor should conduct a given activity or play a given role. A standard of review states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.

In many or most areas of law, these two kinds of standards tend to be conflated. For example, the standard of conduct that governs automobile drivers is that they should drive carefully,1 and the standard of review in a liability claim against a driver is whether he drove carefully.2 Similarly, the standard of conduct that governs an agent who engages in a transaction with his principal that involves the subject matter of the agency is that the agent must deal fairly,3 and the standard of review in a liability claim by the principal against an agent based on such a transaction is whether the agent dealt fairly.4

The conflation of standards of conduct and standards of review is so common that it is easy to overlook the fact that whether the two kinds of standards are or should be identical in any given area is a matter of prudential judgment. Perhaps standards of conduct and standards of review in corporate law would always be identical in a world in which informa-

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1. See, e.g., Levesque v. Anchor Motor Freight, Inc., 832 F.2d 702, 704 (1st Cir. 1987) ("In that jurisdiction, as elsewhere, a driver's duty is to use care which is reasonable under the circumstances . . . "); see also Thomason v. Willingham, 165 S.E.2d 865, 867 (Ga. Ct. App. 1968) (stating that a driver has a common law duty to exercise ordinary care).
2. See Levesque, 832 F.2d at 704.
4. See id. § 390 cmt. f.
tion was perfect, the risk of liability for assuming a given corporate role was always commensurate with the incentives for assuming the role, and institutional considerations never required deference to a corporate organ. In the real world, however, these conditions seldom hold, and the standards of review in corporate law pervasively diverge from the standards of conduct. A byproduct of this divergence has been the development of a great number of standards of review in this area. In the past, the major standards of review have included good faith, business judgment, prudence, negligence, gross negligence, waste, and fairness. An important new development has been the emergence of intermediate standards of review.

Traditionally, the two major areas of corporate law that involved standards of conduct have been the duty of care and the duty of loyalty. The duty of care concerns the standards of conduct and review applicable to a director or officer who takes action, or fails to act, in a matter that does not involve his own self-interest. (I will hereafter refer to such action or inaction as disinterested conduct.) The duty of loyalty concerns the standards of conduct and review applicable to a director or officer in taking action, or failing to act, in a matter that does involve his own self-interest. (I will hereafter refer to such action or inaction as self-interested conduct.)

Traditionally too, the standards of review in care and loyalty cases have for the most part been bipolar. At one pole have been standards of review that are very hard for a plaintiff to satisfy, such as the standards of waste and business judgment. At the other pole have been standards of review that are easier for a plaintiff to satisfy, such as the standards of prudence and fairness. Partly as a result of new statutory provisions, and partly as a result of the emergence of new areas of corporate law, within the last twenty or thirty years the divergence between standards of conduct and standards of review in corporate law has come increasingly close to the surface, and in several areas intermediate standards of review have now evolved to govern important types of conduct.

In this Article, I develop and examine various standards of conduct and review in corporate law, and explore the reasons why courts employ multiple standards of conduct and review and why the standards of conduct and review often diverge. In Part I, I consider the duty of care. In Part II, I consider the duty of good faith. In Parts III, IV, and V, I consider the duty of loyalty, takeovers, and the termination of derivative actions, respectively. Finally, in Part VI, I consider the general problem of why standards of conduct and standards of review diverge.
I. THE DUTY OF CARE

A. Functions and Duties of Directors and Officers

The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence. All law builds on moral, policy, and experiential propositions. The law of negligence is no exception. Under the moral and policy propositions that underlie the law of negligence, if a person assumes a role whose performance involves the risk of injury to others, he is under a duty to perform that role carefully and is subject to blame if he fails to do so. For example, one who assumes the role of driver is under a duty to drive carefully; one who assumes the role of doctor is under a duty to practice medicine carefully; one who assumes the role of judge is under a duty to judge carefully.

Under modern corporate law and practice, the role of officers is to manage the business of the corporation. Those who assume the role of director have several fairly distinct functions to perform. Directors must monitor or oversee the conduct of the corporation's business. Directors must select, compensate, and replace, as required, the principal senior executives. Directors must approve, modify, or disapprove the corporation's financial objectives, major corporate plans and actions, and major questions of choice concerning the corporation's auditing and accounting principles and practices. Finally, directors must decide any other matters that are assigned to the board by law or by a certificate provision or by-law, or assumed by the board under a board resolution or otherwise.

The general standard of conduct applicable to directors and officers in the performance of their functions, in relation to matters in which they are not interested, is set forth in section 4.01 of the ALI's Principles of Corporate Governance:

A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar

Analysis and Recommendations (Proposed Final Draft 1992) [hereinafter Principles of Corporate Governance]. I place heavy emphasis throughout this Article on the American Law Institute's Principles of Corporate Governance. Although the Principles of Corporate Governance is not titled a Restatement—partly because it includes not only provisions addressed to courts, but also provisions addressed to legislatures and provisions of corporate practice—it is essentially a Restatement of corporation law in the areas that I will consider, and therefore provides a useful thread through the maze of competing standards. Many of the passages in the balance of this Article draw very heavily on, and sometimes paraphrase, portions of the Comments and Reporter's Notes that address the issue under consideration. I also have drawn on Melvin A. Eisenberg, Self-Interested Transactions in Corporate Law, 13 J. Corp. Law 997 (1988) and Melvin A. Eisenberg, The Duty of Care of Corporate Directors & Officers, 51 U. Pitt. L. Rev. 945 (1990).

11. See Principles of Corporate Governance, supra note 10, § 3.01.
This standard of conduct has both subjective and objective elements. The standard of "care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances" is an objective standard. The standard, "in a manner that he or she reasonably believes to be in the best interests of the corporation," is both subjective and objective. The director or officer must subjectively believe that his conduct is in the best interests of the corporation, and that belief must be objectively reasonable.

The application of this standard of conduct to the functions of directors results in several distinct duties. Directors must reasonably monitor or oversee the conduct of the corporation's business to evaluate whether the business is being properly managed, primarily by regularly evaluating the corporation's principal senior executives and ensuring that appropriate information systems are in place. This is known as the duty to monitor. Directors must follow up reasonably on information, acquired through monitoring systems or otherwise, that should raise cause for concern. This is known as the duty of inquiry. Directors must make reasonable decisions on matters that the board is obliged or chooses to act upon. Finally, directors must employ a reasonable decision-making process to make decisions.

Officers have comparable duties, although for most officers decision making is likely to be more important than monitoring.

B. The Business-Judgment Standard

On their face, the elements of these duties are fairly demanding. This is particularly true of the element of prudence or reasonability. In prac-

12. Principles of Corporate Governance, supra note 10, § 4.01. Compare § 8.30(a) of the Revised Model Business Corporation Act:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:
(1) in good faith;
(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
(3) in a manner he reasonably believes to be in the best interests of the corporation.


tice, however, the standards of review applied to the performance of these duties are less stringent, especially when the substance or quality of a decision—that is, the reasonableness of the decision, as opposed to the reasonableness of the decision-making process—is called into question. In such cases, a much less demanding standard of review may apply, under the business-judgment rule.13

The business-judgment rule consists of four conditions, and a special standard of review that is applicable, if the four conditions are satisfied, in suits that are based on the substance or quality of a decision a director or officer has made, as opposed to the decision-making process he utilized to arrive at his decision.

The four conditions are as follows:

First, a judgment must have been made. So, for example, a director’s failure to make due inquiry, or any other simple failure to take action—as opposed to a decision not to act—does not qualify for protection of the rule.14

Second, the director or officer must have informed himself with respect to the business judgment to the extent he reasonably believes appropriate under the circumstances—that is, he must have employed a reasonable decision-making process.15

Third, the decision must have been made in subjective good faith—a condition that is not satisfied if, among other things, the director or officer knows that the decision violates the law.16

Fourth, the director or officer may not have a financial interest in the subject matter of the decision.17 For example, the business-judgment rule is inapplicable to a director’s decision to approve the corporation’s purchase of his own property.

If these four conditions are met, then the substance or quality of the director’s or officer’s decision will be reviewed, not under the basic standard of conduct to determine whether the decision was prudent or reasonable, but only under a much more limited standard.

There is some difference of opinion as to how that limited standard should be formulated. A few courts have stated that the standard is whether the director or officer acted in good faith.18 It is often unclear, however, whether good faith, as used in this context, is purely subjective or also has an objective element.

One of the few places where a definition of good faith is codified is the Uniform Commercial Code, but even the Code lacks clarity on this point. The Code’s General Provisions (Part I) provide that good faith means

13. See Principles of Corporate Governance, supra note 10, § 4.01(c).
14. See id.
15. See id. § 4.01(c)(2).
16. See id. § 4.01(c).
17. See id. § 4.01(c)(1).
“honesty in fact in the conduct or transaction concerned.”\textsuperscript{19} Although that definition seems to be subjective, it may not be. A person may be deemed to act honestly if he acts according to his own best lights, or a person may be deemed to act honestly only if he acts according to his own best lights and without transgressing the basic moral standards set by society. Furthermore, under the Code’s Sales provisions (Part II) a merchant’s duty of good faith includes an explicitly objective element—“the observance of reasonable commercial standards of fair dealing in the trade.”\textsuperscript{20} Similarly, in Sam Wong & Son, Inc. v. New York Mercantile Exchange,\textsuperscript{21} Judge Friendly held, in a non-Code context, that in determining whether a person made a decision in good faith it was relevant whether the decision had rationality.\textsuperscript{22} “By this,” he stated, “we mean only a minimal requirement of some basis in reason . . . . Absent some basis in reason, action could hardly be in good faith even apart from ulterior motive.”\textsuperscript{23}

Similarly, most courts have not limited the standard of review under the business-judgment rule to subjective good faith, but instead have employed a standard that involves some objective review of the quality of the decision, however limited.\textsuperscript{24} As William Quillen, formerly a leading Delaware judge, has stated: “[T]here can be no question that for years the courts have in fact reviewed directors’ business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries.”\textsuperscript{25} Even courts that seem to use the term “good faith” in a relatively subjective way nevertheless almost always review the quality of decisions under the guise of a rule that the irrationality of a decision shows bad faith.\textsuperscript{26} Courts have adopted an objective element because a subjective-good-faith standard would depart too far from the general principles of law that apply to private individuals. Serious problems would arise if even an irrational business decision was protected solely because it was made in subjective good faith.

Accordingly, the prevalent formulation of the standard of review under the business-judgment rule, if the four conditions to that rule have been satisfied, is that the decision must be rational.\textsuperscript{27} This rationality

\textsuperscript{19} U.C.C. § 1-201(19) (1990).
\textsuperscript{20} U.C.C. § 2-103(1)(b) (1990).
\textsuperscript{21} 735 F.2d 653 (2d Cir. 1984).
\textsuperscript{22} See id. at 677.
\textsuperscript{23} Id. at 678 n.32.
\textsuperscript{27} See Principles of Corporate Governance, supra note 10, § 4.01(c)(3); see also Mey-
standard of review is much easier to satisfy than a prudence or reasonableness standard. 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. Unlike a subjective-good-faith standard, a rationality standard preserves a minimum and necessary degree of director and officer accountability. Further, a rationality standard allows courts to enjoin directors and officers from taking actions that would waste the corporation's assets.

An obvious example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained. For example, in Selheimer v. Manganese Corp. of America, managers poured a corporation's funds into the development of a single plant even though they knew the plant could not be operated profitably because of various factors, including lack of a railroad siding and proper storage areas. The court imposed liability, because the managers' conduct "defied explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures." In the balance of this Article, I refer to the standard of review that is applied if the conditions of the business-judgment rule are satisfied as the business-judgment standard. Under this standard, a director or officer will not be liable for a decision that resulted in a loss to the corporation, even if the decision is unreasonable, as long as the conditions of the business-judgment rule have been met and the decision is rational.

Although a rationality standard of review is more demanding of a director than a subjective-good-faith standard of review, it is considerably less demanding than the relevant standard of conduct, which is based on reasonableness. Why should such a relatively undemanding standard of review be applicable to the quality of decisions by corporate directors and officers? The answer to this question involves considerations of both fairness and policy.

To begin with, the application of a reasonableness standard of review to the quality of disinterested decisions by directors and officers could result in the unfair imposition of liability. In paradigm negligence cases involving relatively simple decisions, such as automobile accidents, there is often little difference between decisions that turn out badly and bad decisions. In such cases, typically only one reasonable decision could have been made under a given set of circumstances, and decisions that turn out badly therefore almost inevitably turn out to have been bad decisions.

ers, 693 F.2d at 1210-11; Arsht & Hinsey, supra note 24, at 954 (noting that "a belief which motivates a director who is acting in good faith to approve a matter must, a fortiori, be one that is held on a reasonable or rational basis").
29. See Selheimer, 224 A.2d at 639.
30. Id. at 646.
In contrast, in the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A decision maker faced with uncertainty must make a judgment concerning the relevant probability distribution and must act on that judgment. If the decision maker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail, the decision maker has not made a bad decision, because in any normal probability distribution some outcomes will inevitably fall on the unlucky tail.

For example, an executive faced with a promising but expensive and untried new technology may have to choose between investing in the technology or forgoing such an investment. Each alternative involves certain negative risks. If the executive chooses one alternative and the associated negative risk materializes, the decision is “wrong” in the very restricted sense that if the executive had it to do all over again he would make a different decision, but it is not a bad decision. Under a reasonableness standard of review, however, factfinders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors and officers liable for such decisions.

The business-judgment rule protects directors and officers from such unfair liability by providing directors and officers with a large zone of protection when their decisions are attacked. Other kinds of decision makers who must make decisions on the basis of incomplete information and in the face of obvious risks can often shield themselves from liability for decisions by showing that they followed accepted protocols or practices. In contrast, directors and officers can seldom shield themselves in that way, because almost every business decision is unique. Furthermore, unlike most types of negligence cases, negligent decisions by directors or officers characteristically involve neither personal injury nor economic damages that are catastrophic to an individual. The law may justifiably be less willing to take the risk of erroneously imposing liability in such cases.

Furthermore, the shareholders’ own best interests may be served by conducting only a very limited review of the quality of directors’ and officers’ decisions. It is often in the interests of shareholders that directors or officers choose the riskier of two alternative decisions, because the expected value of a more risky decision may be greater than the expected value of the less risky decision. For example, suppose that Corporation C has $100 million in assets. C’s board must choose between Decision X

31. See, e.g., Osborn v. Irwin Memorial Blood Bank, 5 Cal. App. 4th 234, 278 n.13 (Ct. App. 1992) (recognizing that medical practitioners have this defense available because "compliance with accepted practice is generally taken as conclusive evidence of due care.") (quoting Allan H. McCoid, The Care Required of Medical Practitioners, 12 Vand. L. Rev. 549, 560 (1959)).
and Decision Y. Each decision requires an investment of $1 million. Decision X has a 75% likelihood of succeeding. If the decision succeeds, C will gain $2 million. If it fails, C will lose its $1 million investment. Decision Y has a 90% chance of succeeding. If the decision succeeds, C will gain $1 million. If it fails, C will recover its investment. It is in the interest of C's shareholders that the board make Decision X, even though it is riskier, because the expected value of Decision X is $1.25 million (75% of $2 million, minus 25% of $1 million) while the expected value of Decision Y is only $900,000 (90% of $1 million). If, however, the board was concerned about liability for breaching the duty of care, it might choose Decision Y, because as a practical matter it is almost impossible for a plaintiff to win a duty-of-care action on the theory that a board should have taken greater risks than it did. A standard of review that imposed liability on a director or officer for unreasonable as opposed to irrational decisions might therefore have the perverse incentive effect of discouraging bold but desirable decisions. Putting this more generally, under an ordinary standard of care directors might tend to be unduly risk-averse, because if a highly risky decision had a positive outcome the corporation but not the directors would gain, while if it had a negative outcome the directors might be required to make up the corporate loss. The business-judgment rule helps to offset that tendency.

Furthermore, at least in the case of non-management directors, liability for the losses caused by an imprudent business decision would often be far out of proportion to the incentives for accepting a directorship. Outside directors of publicly held corporations typically earn approximately $30,000 annually in directors' fees. In contrast, liability for an imprudent decision can be in the millions. Therefore, in the absence of some brake on such liability, it might become more difficult to attract qualified candidates as non-management directors, which also would be contrary to the shareholders' own best interests.

C. Standards of Validity

Most of the justifications for the business-judgment rule center on liability consequences: in particular, on the potential unfairness of imposing liability for a good decision that turned out badly; on the perverse incentive effects that might result from a reasonability standard of review in liability cases; and on the disproportion between the potential liability for making an imprudent decision and the incentives for serving as an

32. To some extent this may also be true of other areas, such as medical malpractice. However, a physician normally can insulate himself in cases that involve significant but desirable risks by obtaining the patient's informed consent. In contrast, it is normally neither feasible nor desirable for directors or officers to try to obtain the shareholders' consent to proposed business decisions.

outside director.\textsuperscript{34} Insofar as the business-judgment rule rests on these liability-centered justifications, it would be theoretically possible to apply a different standard of review when the issue is not whether to impose personal liability on a director or officer on the basis of disinterested conduct, but whether to uphold the validity of a disinterested decision if only injunctive relief is sought.

Joseph Hinsey has argued for just such a distinction,\textsuperscript{35} and there is at least modest support in the case law for employing different standards of review in these two types of cases. A long line of Delaware decisions has held that an arm's-length combination of corporations is subject to judicial review to determine whether the price is so grossly inadequate as to amount to "constructive fraud."\textsuperscript{36} This rule was applied in a striking manner by then-Chancellor Quillen in *Gimbel v. Signal Companies*.\textsuperscript{37} Signal Companies had agreed to sell its stock in a wholly owned subsidiary, Signal Oil, to Burmah Oil for a price in excess of $480 million. Negotiations between Burmah and Signal representatives began in October 1973. Before then, independent petroleum geologists had valued Signal Oil's oil and gas reserves at $230-260 million as of June 30, 1973, and an expert in oil properties had valued the petroleum properties at $350 million as of September 13, 1973. A special meeting of Signal's board was called to consider Burmah Oil's offer for Signal Oil. Despite the intervening oil crisis, no updated evaluation of Signal Oil's oil and gas reserves was presented, and no effort was made to determine if other companies would offer a higher price. The court ordered a temporary injunction against the sale, although it seems doubtful that liability would have been imposed on the directors if a suit for damages after the sale had been completed.\textsuperscript{38}

\begin{itemize}
  \item \textsuperscript{34} See supra text accompanying notes 32-33.
  \item \textsuperscript{36} See *Gimbel v. Signal Companies*, 316 A.2d 599 (Del. Ch.), aff'd per curiam on limited grounds, 316 A.2d 619 (Del. 1974).
  \item \textsuperscript{37} \textit{Id.}
  \item \textsuperscript{38} The court said:
    although the language of 'constructive fraud' or 'badge of fraud' has frequently and almost traditionally been used, such language is not very helpful when fraud admittedly has not been established. There are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price.
    \textit{Id.} at 610. The court framed the issue in the case to be, "did the Signal directors act recklessly in accepting a wholly inadequate price for Signal Oil?" \textit{Id.} at 611. It pointed out that:
    There is no question that the energy crisis has created a drastic change in the value of oil and gas properties. Even granting that there may be wide divergence in expert viewpoint, the situation made desirable an updated evaluation since the Hill evaluation as of September 30 and the De Golyer and MacNaughton evaluation as of June 30.
    \textit{Id.} at 615. After stressing that "the ultimate question is not one of method but one of value," the court concluded:
\end{itemize}
Despite the ruling in *Gimbel*, it is not clear that the employment of different standards of review in liability and validity contexts has caught hold in the context of ordinary business decisions. The lack of enthusiasm for such a distinction in that context may be based on the difficulty of reviewing the quality of business judgments, on respect for the value of institutional autonomy when directors have acted in a disinterested manner, or on a hesitation to formulate yet one more finely graded standard of review. However, as I will show in Part IV, the ALI's *Principles of Corporate Governance* does draw a distinction between liability and validity cases in the extraordinary context of takeovers.39

D. The Due-Care Standard

The justifications of the business-judgment rule help explain why the business-judgment standard is generally applicable to a review of the quality of decisions, but not to a review of the duty of monitoring, the duty of inquiry, or the duty to employ a reasonable decision-making process.

For one thing, although the law should not discourage directors and officers from making bold decisions, it should encourage directors and officers to pay attention to their duties.

For another, a review of whether a director or officer has complied with the monitoring and process aspects of his role—such as attending meetings, reading reports, and doing his homework—will usually be subject to less risk of error than a review of whether a decision that the director or officer made was reasonable.40

More broadly, a review of the quality of directors' and officers' decisions would typically involve, among other things, a determination of what risk levels the corporation should have accepted and what risks it should have undertaken—a kind of review that would not only be extremely difficult but would threaten to impinge seriously on corporate
autonomy. In contrast, the general duty to monitor, the duty to make due inquiry, and the duty to employ a reasonable decision-making process typically do not involve such determinations and are therefore consistent with corporate autonomy concerning those determinations.

Finally, the potential liability of a director for failure to comply with the monitoring and process aspects of his role may seem more commensurate with the incentives for serving as a director, and with the degree of fault involved, than the imposition of such liability on a director who employed a reasonable decision-making process but arrived at an unreasonable decision.

Accordingly, the duty to monitor, the duty of inquiry, and the duty to employ a reasonable decision-making process are normally not protected by the business-judgment rule. Even in the case of these duties, however, the standard of review may depart somewhat from the relevant standard of conduct. A few courts have expressed this difference by adopting a rule that the standard of review in such cases is whether the director was "grossly negligent." The concept of gross negligence, however, is notoriously ambiguous, and in practice it is common to find that courts that purport to apply that standard actually apply a standard that is either more or less demanding. For example, a gross-negligence standard of review is often associated with Delaware, but in the famous case of Smith v. Van Gorkom the Delaware court, although purporting to apply that standard of review, in fact held outside directors to be liable for conduct that many observers believe did not constitute even ordinary negligence. Conversely, in Rabkin v. Philip A. Hunt Chemical Corp., decided after Smith v. Van Gorkom, Vice-Chancellor Berger stated that the gross-negligence test did not apply across the board:

The Hunt directors argue that [in] a claim of director neglect . . . the gross negligence standard should be applied for legal and practical reasons.

. . .

I conclude that ordinary negligence is the appropriate standard of liability in director neglect claims. I am satisfied that . . . Van Gorkom did not adopt the gross negligence standard in [such] claims . . . .

Courts that purport to adopt a gross-negligence standard to review the duty to monitor, the duty of inquiry, or the duty to employ a reasonable decision-making process, probably do so because the performance of

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42. 488 A.2d 858 (Del. 1985).


44. Id. at 1216-17 (emphasis added). On the flip side, some courts appear to say that the standard of review in business-judgment cases is gross negligence. In that context, the gross-negligence standard of review would be unduly strict.
these duties seldom presents a cut-and-dried issue, and the gross-negligence standard of review emphasizes the importance of leaving a play in the joints in determining whether the relevant standard of conduct was satisfied in such cases. A play in the joints, however, is built into the very concept of due care. For example, in the Rabkin case Vice-Chancellor Berger stated that even under an ordinary-negligence standard, "corporate directors will face no liability for the failure to focus on an isolated bit of information."45

The same point can be made, without using the problematic gross-negligence standard, by employing the terminology of due care rather than the terminology of negligence, and by making clear that in determining whether directors or officers acted with due care, courts should consider the complexities of the corporate context and give a certain amount of running room.46

II. THE DUTY OF GOOD FAITH

It is well established that directors and officers must act in good faith.47 Although this standard of conduct is usually treated as an aspect of the duty of care,48 in fact it is distinct from that duty. For example, one aspect of the duty of good faith is that a director or officer may not knowingly cause the corporation to take an action that violates the law, even if a reasonable person would believe that, balancing all probable gains and losses, the action would enhance corporate profits.

The duty of good faith has been the subject of only limited analysis, partly because it often has been folded into the duty of care. A full development of the meaning of the duty of good faith, insofar as that duty goes beyond the obligation not to act in a knowingly illegal manner, would extend beyond the compass of this Article. I will therefore reserve that discussion for separate treatment, and point here only to the important discussion of that duty in In re RJR Nabisco, Inc. Shareholders Litigation,49 where Chancellor Allen stated that an action by a director is not in good faith if it is based on "any human emotion [that] may cause a director to place his own interests, preferences or appetites before the welfare of the corporation," including "hatred, lust, envy, revenge, . . . shame or pride."50

Because the duty to act in good faith is a baseline duty and does not implicate the issues of risk and the like raised by the duty of care, the

45. Id. at 1216-17.
46. See Principles of Corporate Governance, supra note 10, Part IV Introductory Note, § 4.01, § 4.01 cmt. e.
47. See id. at § 4.01(a).
48. See id.
50. Id. at 91,711.
standard of review for violating that duty should be identical to the standard of conduct that the duty demands.

III. THE DUTY OF LOYALTY

A. The Basic Standard of Conduct and Standard of Review

When a director or officer acts in a manner in which his self interest is involved, the standard of conduct is that he must act or deal fairly. Like the standard that governs disinterested decision making, the standard of fair dealing has both a substantive and a procedural aspect. These two different aspects are sharply presented in cases involving self-interested transactions between a director or officer and the corporation. In such cases, the substantive aspect of fair dealing requires that the terms of the transaction must be fair\(^5\)—meaning, essentially, that the terms the corporation gives or gets should be the terms it would have given or gotten if it had dealt on the market—and that the transaction must be in the corporation’s best interests. The procedural aspect of fair dealing requires that the transaction and its terms must be arrived at through a fair process. For example, the director or officer must make full disclosure concerning the transaction\(^5\) and must explain the implications of the transaction if he is in a position to realize those implications and the persons representing the corporation are not.\(^5\)

The disclosure obligation is especially important. A director or officer who fails to make full disclosure has failed to deal fairly, even if the substantive terms of a transaction are fair. In many contracts fairness is a range, rather than a point, and disclosure of a material fact might have induced the corporation to bargain the price down lower in the range. Furthermore, the terms of a self-interested contract might be “fair” in the sense that they correspond to the market terms for the relevant subject-matter, but the corporation might have refused to make the contract if disclosure had been made of a material fact that would have shown that entering into the contract was not in the corporation’s interest. This point is exemplified in Illustration 7 to section 5.02(a)(1) of the Principles of Corporate Governance:

[X Corporation is seeking a new headquarters building. D, a vice president of X Corporation, owns all the stock of R Corporation, which owns an office building. D causes a real estate agent to offer R Corporation’s building to X Corporation. X Corporation’s board of directors agrees to purchase the building for a fair price (that is based on market conditions)]. D discloses to X Corporation, prior to the acquisition, his interest in R Corporation. D fails to disclose, however, that he has information, not publicly available, that the State Highway Department has formally decided to run a highway through the prop-

\(^{51}\) See Principles of Corporate Governance, supra note 10, § 5.02(a).

\(^{52}\) See id. § 5.02(a)(1).

\(^{53}\) See id. § 5.02 cmt. d.
property on which R Corporation's building stands, and to condemn the building under its power of eminent domain. The price paid by X Corporation is fair, even taking the proposed condemnation into account, since the condemnation award is likely to equal or exceed the price. Two weeks after the acquisition, X Corporation learns of the Highway Department's decision. D has not fulfilled his duty [of fair dealing] to the corporation . . . . 54

The obligation to deal fairly when self-interest is involved attaches to a number of different types of transactions and conduct: transactions with the corporation that do not involve compensation, 55 transactions that involve compensation, 56 the taking of corporate opportunities, 57 competition with the corporation, 58 and the use by a director or officer of corporate position, corporate property, or corporate information for his own pecuniary advantage. 59 I will focus here on transactions with the corporation that do not involve compensation. For convenience, I refer to such transactions as self-interested transactions.

Suppose that a self-interested transaction has not been approved by disinterested directors or shareholders. In such cases, the standard of review is the same as the standard of conduct—whether the director or officer has dealt fairly, on both the substantive and the procedural levels. 60 I will call this the pure-fairness standard. Unlike the due-care standard, the pure-fairness standard gives virtually no running room, except to the extent that it recognizes that fairness is typically a range rather than a point. 61

It is easy to see why this relatively strict standard of review should be applied to self-interested transactions. In a perfect market involving homogeneous goods, there would usually be no reason for a corporation to transact with a director or senior executive instead of transacting on the market. Even in imperfect markets involving differentiated goods, there are probably few instances in which a director or senior executive can offer the corporation a commodity for which there is no market substitute. Accordingly, such an off-market transaction may properly be regarded as exceptional, and therefore in need of a clear justification that it was fair. For the same reason, the burden of proof is on the director or senior executive to prove that such an off-market transaction was fair.

B. The Standard of Review When There Has Been Approval by Disinterested Directors

The issue becomes more complex when a self-interested transaction

54. Id. § 5.02(a)(1), illus. 7.
55. See id. § 5.02.
56. See id. § 5.03.
57. See id. § 5.05.
58. See id. § 5.06.
59. See id. § 5.04.
60. See id. § 5.02.
61. See id. § 5.02(a)(2)(A) cmt.
has been approved by disinterested directors. Certainly in such cases there must be a review for full disclosure, because the approval of the disinterested directors is meaningless without full disclosure. The more difficult issue is whether the approval changes the standard of review of substantive fairness. It is sometimes argued that if disinterested directors approve a self-interested transaction, and the approval satisfies the conditions of the business-judgment rule, the business-judgment standard of review should be applied because the board has made a disinterested decision.

Applying the business-judgment standard of review in these cases would, however, be inappropriate. To begin with, because of their collegial relationships directors are unlikely to treat one of their number with the degree of wariness with which they would approach transactions with third parties.

Furthermore, it is difficult, if not impossible, to employ a definition of "disinterested" in corporate law that corresponds with factual objectivity. A director called upon to approve a self-interested transaction would be factually objective if he had no significant relationship of any kind, with either the interested director or officer or the subject matter of the self-interested transaction, that would be likely to affect his judgment. Objectivity is, in short, the disinterestedness we expect from a judge. A proper test for objectivity would therefore be the test applied to recusal of judges, that is, whether the director's "impartiality might reasonably be questioned.")

For corporate-law purposes, however, it is desirable to define interestedness in a bounded manner, to include only financial and close familial relationships, because a corporate-law definition that turned on objectivity or impartiality would seriously diminish the protection afforded by the business-judgment rule. The business-judgment rule protects only directors who are defined as disinterested. If the corporate-law definition of disinterestedness corresponded to objectivity or impartiality, the protection of the business-judgment rule would be undesirably withheld from a director who had no financial or close familial ties to a party to a transaction but nevertheless had relationships of a sort that would be likely to affect his impartiality. For example, if a judge is a long-time friend of a party and was the maid of honor at her wedding, the judge should recuse herself, because her impartiality might reasonably be questioned. If a director had such a relationship, however, we would not want to label her "interested" for corporate-law purposes and thereby remove the protection of the business-judgment rule.

In practice, therefore, for corporate-law purposes interestedness is defined in a bounded way, to include only certain kinds of interestedness. For example, under section 1.23 of the Principles of Corporate Govern-

62. See id. § 5.02.
a director or officer is "interested" in a transaction if, for example, he has "a material pecuniary interest in the transaction" or has a "business, financial, or familial relationship with a party to the transaction, and that relationship would reasonably be expected to affect [his] judgment with respect to the transaction in a manner adverse to the corporation." Because directors who are disinterested under the bounded corporate-law definition may nevertheless not be factually objective, the law should require a fairness review even of self-interested transactions that have been approved by "disinterested" directors.

Finally, the realities of director action must be taken into account. The board of a publicly held corporation seldom formulates decisions in the first instance. Instead, when board decisions are required, the board normally acts by approving, rejecting, or modifying a proposal that has been formulated and recommended by the principal senior executives. Furthermore, a board can be expected to have great confidence in, and place great reliance on, such recommendations, because if the board does not have a high level of confidence in the principal senior executives, it should already have replaced them. Consequently, at least in those cases in which the board is called upon to approve a self-interested transaction involving principal senior executives, the board's sole source of advice may be the proponent of the transaction. In short, unlike the typical business decision, in determining whether to approve a self-interested transaction involving principal senior executives, disinterested directors may receive only self-interested advice.

A review of the substantive fairness of a self-interested transaction that has been approved by disinterested directors can also be thought of as a surrogate for a review of the fairness of the process by which those directors approved the transaction. In a world with perfect information, a court could always determine directly whether disinterested directors who approved a self-interested transaction approached the transaction with the appropriate degree of wariness, whether they were factually objective, whether they had proper advice, and so forth. Because we do not live in such a world, courts may need to make these determinations by indirect means. If a self-interested transaction that has been authorized by disinterested directors is substantively unfair, courts can normally infer that the approving directors were not objective in fact, that they were not as wary as they should have been because they were dealing with a colleague, or that they did not have good advice.

Nevertheless, it is appropriate to give some weight to the approval of disinterested directors, both on the ground of institutional autonomy, and because if such approval provides some insulation against liability, interested directors and officers will have a strong incentive to bring proposed self-interested transactions before disinterested directors at an
early stage. These objectives can be accomplished by adopting an intermediate standard of review, rather than a pure-fairness test, when a self-interested transaction has received such approval. Under section 5.02 of the ALI's Principles of Corporate Governance, for example, if disinterested directors properly approve a self-interested transaction, the plaintiff rather than the defendant bears the burden of proof, and the standard of review is whether disinterested directors could have reasonably believed that the transaction was fair to the corporation. This standard is intended to be easier for the interested director or officer to satisfy than a pure-fairness standard but harder to satisfy than the business-judgment standard. The intermediate standard of review of self-interested transactions that have been properly approved by disinterested directors accommodates both the need to make self-interested transactions reviewable for fairness, on the one hand, and the value of institutional autonomy and the desirability of providing self-interested directors and officers with an incentive to seek early approval from disinterested directors, on the other.

C. The Effect of Conflict-of-Interest Statutes

Since the 1950s, most states have adopted conflict-of-interest statutes concerning the effect of approval of self-interested transactions by disinterested directors. Although the statutes vary in important ways, they typically provide that a transaction will not be void or voidable solely because it is self-interested if it is fair or if disinterested directors approve it.

Some of these statutes explicitly require a fairness review even if a transaction was approved by disinterested directors. The remaining statutes are susceptible to two very different interpretations. On the one hand, they can be interpreted to mean that approval by disinterested directors is an alternative to a fairness review. On the other, they can be interpreted as intended merely to change the common law rule that self-interested transactions are voidable without regard to fairness, and not to preclude a review for fairness. Thus, in adopting section 41 of the prior version of the Model Act—the ABA's Committee on Corporate Laws stated that "[t]he function of section 41 is not to provide a basis for validating for all pur-

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65. See Principles of Corporate Governance, supra note 10, § 5.02.
poses a contract or transaction between an interested director and his corporation, but simply to establish that such contract or transaction is not automatically void or voidable solely by reason of the director's interest," and that "[i]n all other respects equitable principles will continue to be applicable."\textsuperscript{73}

Although courts have come down on both sides of the issue,\textsuperscript{74} it is widely understood that, statute or no statute, approval of a self-interested transaction by disinterested directors will not prevent a court from applying to self-interested transactions a "smell" test that is more rigorous than the business judgment rule. At a minimum, such a test can be imported into the statutes through the concept of good faith. Many of the statutes explicitly require approval by disinterested directors to be in good faith.\textsuperscript{75} Furthermore, since directors are always obliged to act in good faith\textsuperscript{76} such a requirement can be implied even where it is not explicit. Because good faith can be given an objective as well as subjective content,\textsuperscript{77} this good faith requirement allows a judicial inquiry into fairness, since the courts can hold that a transaction that is clearly unfair cannot be approved in good faith.

Similarly, although a new version of the Model Act's conflict-of-interest provisions,\textsuperscript{78} which has been adopted in several states,\textsuperscript{79} provides that a director's self-interested transaction may not be attacked if the transaction is properly approved by disinterested directors,\textsuperscript{80} an important passage of the Comment adds that terms of a transaction that are "manifestly unfavorable" to the corporation could constitute probative evidence.

\textsuperscript{73} Model Business Corp. Act Ann. § 41 cmt. (1971).

\textsuperscript{74} Compare Cohen v. Ayers, 596 F.2d 733, 740-41 (7th Cir. 1979) (holding that, under New York statute, ratification of a transaction by disinterested directors or by shareholder vote can relieve a director of the burden of proving that a transaction was fair and shift the burden to the challenging party, who must show that the transaction was unfair) and Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. Dist. Ct. App. 1952) (holding that statute does not automatically validate transactions because of disclosure and approval by majority of shareholders) and Holi-Rest, Inc. v. Treloar, 217 N.W.2d 517, 525 (Iowa 1974) (holding that Iowa statute does not modify its common law rule which requires a corporation-controlling director, challenged in a self-dealing transaction, to carry the burden to establish fairness) and Aronoff v. Albanese, 85 A.D.2d 3, 6 (N.Y. App. Div. 1982) (stating that, under New York law, ratification shifts the burden of proof of fairness to the opponents of the transaction, but does not automatically validate the transaction) with Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (dictum) (approval by fully informed disinterested directors or shareholders permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with burden of proof on the party attacking the transaction) and Citron v. E.I. Dupont de Nemours & Company, Fed. Sec. L. Rep. (CCH) ¶ 95,420 at 97,125 (Del. Ch. 1990) (dictum) (quoting with approval Marciano, 535 A.2d at 405 n.3).


\textsuperscript{76} See supra text accompanying notes 47-50.

\textsuperscript{77} See supra text accompanying notes 18-23.


evidence that the directors' action did not constitute proper approval. This "manifestly unfavorable" test, like the smell test, is essentially an implicit intermediate test, comparable to the explicit test of section 5.02 of the Principles of Corporate Governance. The explicit standard of section 5.02, which is intended to serve as a guide to interpretation of the statutes as well as a statement of the law applicable when the statutes do not apply, is preferable to the tacit smell test or the implicit intermediate standard of the Model Act, because it promotes transparency of decision making by allowing the courts to do explicitly what all agree they will find some way to do in any event.

D. The Standard of Review When There Has Been Approval by Disinterested Shareholders

Suppose now that a self-interested transaction has been approved by disinterested shareholders? In such cases, plausible arguments can be made for several very different standards of review.

Self-interested transactions are likely to involve matters that would constitute ordinary business transactions were it not for the self-interest involved, and amounts of money that are relatively small compared to the corporation's total value. Therefore, it is hard to be confident that shareholders who are sent a proxy statement that includes a proposal for the approval of such a transaction will both study and fully understand the relevant issues. Accordingly, at least in the case of a publicly held corporation, a very forceful argument can be made that shareholder approval of self-interested transactions should not be given any weight at all, or at most should only serve to shift the standard of review from a full-fairness standard to an intermediate standard.

At the other extreme, it can be argued that if full disclosure is made, approval of self-interested decisions by disinterested shareholders should be conclusive and unreviewable, partly because the shareholders own the corporation, and partly because, at least in the publicly held corporation, disinterested shareholders will normally have no relations whatsoever to the self-interested director or officer and therefore will be factually objective.

Still another alternative is to review self-interested decisions that have been approved by disinterested directors under the standard of waste. That standard has been variously defined. As formulated in section 1.42 of the Principles of Corporate Governance, which is generally congruent on the issue with Delaware law,

[a] transaction constitutes a 'waste of corporate assets' if it involves an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose, or, if consideration is received in exchange, the consideration the corporation receives is so inadequate in

value that no person of ordinary sound business judgment would deem it worth that which the corporation has paid.\textsuperscript{82}

The waste standard is a counterpart of the business-judgment standard. The argument for this standard is that it accommodates the competing concepts in this area—on the one hand, the concepts that shareholders are the owners of the corporation and that disinterested shareholders are factually objective, and on the other hand, the concept that the limitations of proxy voting prevent shareholder approval of a self-interested transaction from being meaningful.

E. Standard of Review in Compensation and Corporate Opportunity Cases

It would be tedious to discuss the standard of review that should govern every permutation of self-interested conduct, and I shall therefore consider only two further cases.

The first of these cases consists of self-interested transactions that involve compensation. Compensation transactions differ from other self-interested transactions in important respects. Because the appropriate amount of compensation depends heavily on each manager's individual characteristics, it is difficult to find market equivalents to measure the substantive fairness of compensation. Also, unlike other self-interested transactions, in the case of compensation no justification is needed to explain why the corporation chose to deal with an insider, rather than transacting with a third party on the open market. Perhaps for these reasons, the cases hold that if a compensation transaction has been properly approved by disinterested directors it will be reviewed only under a business-judgment standard.\textsuperscript{83} In the absence of approval by disinterested directors or shareholders, however, compensation transactions must satisfy the pure-fairness standard of review.

The second case is that in which a director or senior executive takes a corporate opportunity after the opportunity has first been offered to the corporation and rejected by disinterested directors. In the case of a self-interested transaction with the corporation, substantive fairness can be determined by comparing the terms of the transaction with the terms of comparable market transactions. In contrast, when disinterested directors reject a corporate opportunity—because, for example, it is unsuitable for the corporation or insufficiently profitable to justify the

\textsuperscript{82} Principles of Corporate Governance, \textit{supra} note 10, § 1.42. See Grobow \textit{v.} Perot, 539 A.2d 180, 189 (Del. 1988); \textit{see also} Michelson \textit{v.} Duncan, 407 A.2d 211, 224 (Del. 1979) (a transaction constitutes waste when its terms are such that "no person of ordinary sound business judgment would say that the consideration received . . . was a fair exchange for [what was given by the corporation]") (quoting Kaufman \textit{v.} Schoenberg, 91 A.2d 786, 791 (Del. Ch. 1952)).

investment required—there is no objective benchmark, like a market, against which to measure whether the corporation should have accepted the opportunity. To put this differently, a court can override a decision of disinterested directors concerning the fairness of a transaction with a director or officer, without making a business judgment, simply by determining and comparing the terms offered in the market. In contrast, a court could override the decisions of disinterested directors concerning whether the corporation should have taken a corporate opportunity only by making a complex business judgment—after gaining an understanding of the corporation's finances and business policies, plans, and goals—whether the probable benefits of the opportunity to the corporation justified the opportunity's probable costs.

Given the difficulty of such a judgment, if an opportunity was offered to the corporation, with full disclosure, and disinterested directors determined that the corporation should reject the opportunity, a director should not be held liable unless the conditions of the business-judgment rule were not met or the business-judgment standard of review was not satisfied. Generally speaking, however, a director or senior executive cannot take a corporate opportunity without first offering it to the corporation. Furthermore, if a director or officer offers the opportunity to the corporation, and it is rejected, but not by disinterested directors, the director or senior executive must prove that the rejection was fair.

IV. Tender Offers

Over the last twenty years, corporation law has tried to come to grips with the hostile tender offer—that is, a general offer to purchase all or a controlling amount of a corporation's shares from the shareholders, over management's objections. Although such offers are made to the shareholders, rather than to the corporation, often the board of a corporation for whose shares a tender offer has been made causes the corporation to take an action that will tend to block consummation of the offer.

The standard of conduct that should govern such a blocking action is that the action should be reasonably designed to advance the best interests of the corporation and the shareholders. The standard of review presents a more complex problem. If a tender offer succeeds, the top managers will normally lose their jobs. Therefore, actions to block tender offers resemble self-interested conduct. Usually, however, blocking actions are authorized by outside directors, not by managers, and unlike managers, who typically stand to lose their jobs if the takeover succeeds, outside directors ordinarily have no significant economic self-interest in blocking a tender offer. Blocking actions also differ from most other self-interested actions in other respects. Unlike a self-interested

84. See Principles of Corporate Governance, supra note 10, § 5.05(a)(3)(B).
85. See id. § 5.05(c).
86. See id. § 6.02(b)(1).
transaction, a blocking action may be beneficial to shareholders even if it is taken for the wrong reasons. Because of the obstacles to shareholder collective action in publicly held corporations, it may be desirable for the board to take a blocking action whose effect is to facilitate an auction that will maximize the tender-offer price, regardless of the board's motivation. Moreover, a tender offer is typically a highly complex business transaction, and shareholders will often need management's expertise to evaluate the offer.

The resolution of these conflicting factors suggests a split in the standards of review in injunctive and liability settings. In an injunctive setting a blocking action should be reviewed under an intermediate standard even if it has been approved by disinterested directors, because in evaluating a tender offer directors usually rely very heavily on advice from principal senior executives, and these recommendations are self-interested. Accordingly, just as traditional self-interested transactions should be reviewed under an intermediate standard even if they have been approved by disinterested directors, so too should an intermediate standard apply to a decision to block a tender offer even if the decision is made by disinterested directors.

Some cases have applied an intermediate standard of review to blocking actions by treating such actions in terms of the duty of loyalty if the action was motivated by the directors' desire to entrench themselves in office. Similarly, Delaware has adopted an intermediate standard of review under which directors who take a blocking action must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and that their blocking action was a reasonable response to the threat posed. Section 6.02(a) of the Principles of Corporate Governance also adopts an intermediate standard of review in the case of suits for injunctive or other equitable relief. The test under section 6.02(a) is, essentially, whether the directors' action was a reasonable response to the offer.

There are good reasons, however, for not applying that standard of review in a liability setting. If an intermediate standard of review was applied in the takeover context in liability cases, directors might be reluctant to act on the shareholders' behalf in resisting a tender offer, for fear of liability. Moreover, as a practical matter injunctive actions are the key legal setting in takeover contests. If the standard of review was the same in injunctive and liability settings, in actions for injunctive relief the

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89. See Principles of Corporate Governance, supra note 10, § 6.02(a).
courts would often be under pressure to permit a transaction to stand simply because the alternative would also entail very substantial personal liability for the directors. In contrast, when the standards of review in injunctive and liability settings are split, in an injunctive action a court can focus on whether a blocking action is reasonable without being distracted by concern over the liability implications of its decision. In the takeover context, therefore, the Principles of Corporate Governance follows a line it could have taken, but did not, in the context of ordinary business decisions, and applies an intermediate standard of review to validity issues but a business-judgment standard of review to liability issues.90

V. Remedies

A critical area in corporate law is the role and power of the board in derivative actions. The standard of conduct in this area is that the board should act with due care and in the interests of the corporation. The central question is the standard of judicial review that should be applied to a board determination that a derivative action should not proceed. This issue may arise in several contexts. One of these contexts concerns the effect of the board’s rejection of a shareholder’s demand to bring such an action. The standard of review governing such a rejection should generally be congruent with the standard of review that would apply to the underlying transaction that is the subject of the demand—otherwise, the latter standard could be seriously undercut. Therefore, if the underlying transaction would be reviewed under the business-judgment standard, that standard of review should also apply to the rejection. On the other hand, if the underlying conduct would be reviewed under a more demanding standard, so should the board’s rejection of a demand to bring an action based on that conduct. Accordingly, in the latter type of case an intermediate standard of review should be applied—that the plaintiff has pleaded with particularity facts that raise a significant prospect that disinterested directors could not reasonably have determined that rejection of the demand was in the best interests of the corporation. This position is taken in section 7.04 of the Principles of Corporate Governance.91 Although the case law on the issue is somewhat confused and not well articulated,92 section 7.04 probably reflects what the courts have actually done.

Suppose, however, that the board does not reject a demand, or that the board cannot effectively reject a demand because there is not a majority of disinterested directors capable of objective judgment in the circumstances, or that a majority of disinterested directors rejects a demand but the rejection does not meet the relevant standard of review. In such

90. See id. § 6.02(a), (c).
91. See Principles of Corporate Governance, supra note 10, § 704.
cases, the board, acting through disinterested directors, can investigate the complaint and, if it concludes that prosecution of the action is against the corporation’s best interests, can move that the complaint be dismissed on that ground. Again, the standard of review of the board’s determination should be congruent with the standard of review that would apply to the underlying transaction. If the underlying transaction would be governed by the business-judgment rule, the standard of review of the board’s determination should be the business-judgment standard. If a more demanding standard of review would apply to the underlying transaction, an intermediate standard of review should apply to the board’s determination.

This position is taken in the Principles of Corporate Governance: Under section 7.10, if the underlying transaction would be reviewed under an intermediate standard or the pure-fairness standard, the standard of review of a board determination is that the board must have been adequately informed under the circumstances and must have reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant reliance. As in the case of demand, the case law on this issue is varied and inconsistent. Delaware, like the Principles of Corporate Governance, employs a bifurcated standard of review, but the bifurcation is along a different line than that employed in section 7.10. Under the Delaware test, if either (i) a majority of the board is interested, or (ii) the plaintiff has alleged with particularity facts that, taken as true, would support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment, then the standard of review is whether the board’s conclusions are soundly based. Furthermore, in such cases the court has discretion to substitute its own business judgment even if the board’s conclusions are soundly based. If neither condition (i) nor (ii) is satisfied, then the standard of review is the business-judgment rule. The meaning of condition (ii) is obscure, but it opens the door to, and virtually invites, some degree of substantive review even if a majority of the directors is disinterested. Accordingly, although the Delaware formulation differs from that in section 7.10, in any given case it is likely that a Delaware court would come to the same result as would a court that applied section 7.10, and much the same is probably true of non-Delaware courts.

VI. WHY STANDARDS OF CONDUCT AND STANDARDS OF REVIEW DIVERGE IN CORPORATE LAW

Parts I-V developed the standards of conduct and the standards of

93. See Principles of Corporate Governance, supra note 10, § 7.10. In addition, § 7.10(b) singles out for special treatment certain violations of the duty of fair dealing involving the retention of a significant improper benefit.


95. See Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).
review in corporate law, examined the justifications for the various standards, and showed how the standards of review and the standards of conduct pervasively diverge. This divergence raises two related questions. First, is it meaningful to talk about a standard of conduct that differs from the standard under which that conduct will be reviewed? Second, what accounts for the pervasive divergence between the two types of standards in corporate law?

These questions can best be addressed by setting them in a wider context. The distinction between standards of conduct and standards of review in corporate law is an instance of a more general distinction in the law between conduct rules, which are rules addressed to the general public, and decision rules, which are rules addressed to officials. The kinds of rules that I call standards of conduct are conduct rules, addressed to directors and officers. The kinds of rules that I call standards of review are decision rules, addressed to judges.

The distinction between conduct rules and decision rules, which can be found in Bentham,96 has been developed and trenchantly analyzed by Meir Dan-Cohen in his important article, Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law.97 Dan-Cohen begins by pointing out that it is common to take one of two reductionist views concerning conduct rules and decision rules. Under one of these views the law consists primarily of decision rules, from which conduct rules are implied. This view is incorrect, because it obscures the character of law as a means of social control in general, and as a means of guiding behavior in particular. Under a second reductionist view, the law consists primarily of conduct rules, which are applied or enforced by the courts. This view is also incorrect, because in deciding a case the judge is not the addressee or subject of the conduct rule he applies. For example, the conduct rule that prohibits theft does not regulate the conduct of a judge who is deciding a theft case. Rather, the conduct of the judge in a theft case is determined by decision rules concerning how cases in which theft is alleged should be decided and what sanctions should be imposed on a person found guilty of theft.98

Dan-Cohen then points out that it may often be desirable to utilize different contents in linked conduct and decision rules. To make this point, he suggests that we imagine a world in which officials and the general public each occupied separate, acoustically sealed chambers, so that neither group could hear the messages in the rules that the legislature directed to the other group. Suppose that the legislature of this imaginary world was considering whether duress should be a defense to a charge of crime. As a matter of policy, the legislature might want to reject a duress defense so to maximize the likelihood that members of the

98. See id. at 628-30.
society will obey the law. As a matter of compassion or fairness, however, the legislature might want to recognize the defense.

In a world in which courts and members of the general public could both perfectly hear—understand—the rules addressed to the other, it would be difficult for the legislature to avoid choosing between its two conflicting goals. In the imaginary world of acoustic separation, however, the legislature could accomplish both of its ends, by telling the general public that duress was not an excuse, while telling the courts that it was.

In the real world, complete acoustic separation is not possible. As a result, each audience, general public and officials, may hear the rules addressed to the other. In practice, therefore, conduct rules normally have decisional side effects and decisional rules normally have conduct side effects. That is one of the reasons why conduct rules and decision rules tend to be conflated. Nevertheless, whether the conduct and decision rules that govern any given issue should be conflated is a matter of prudence, not logic or necessity. Furthermore, under certain conditions even in the real world there may be a kind of partial acoustic separation, so that members of the general public may not take full account of decisional rules in deciding how to act.

In important respects, corporate law presents a textbook case of the distinction between conduct rules and decisional rules. Some areas of law, like civil procedure and administrative law, consist almost entirely of decisional rules. In many other areas, like property and torts, most of the explicit rules are conduct rules, and decision rules are only implied or constructed. Corporate law, in contrast, consists of both conduct rules and relatively explicit decisional rules. This is most obvious in those cases where the standard of review is dramatically shifted when a given type of conduct has been approved by a designated corporate organ, while the standard of conduct remains unchanged. Furthermore, as such cases illustrate, corporate law is marked by not only an explicit but a pervasive divergence between the contents of linked conduct and decision rules.

This returns us to the first of the two questions with which this Part began: is it meaningful to talk about a standard of conduct that differs from the standard under which that conduct will be reviewed? More particularly, in such a case is not the standard of review the standard of conduct? To put these questions in a somewhat different, affirmative form, it might be argued that where the standards of conduct and review diverge in corporate law, the standard of review represents the morality of duty, while the standard of conduct represents only a morality of aspiration. These questions and this argument, however, are merely forms of the reductionist view that the law consists primarily of decision rules, from which conduct rules are implied, and are subject to the criticism

99. See id. at 630-36.
applicable to that view. Standards of conduct in corporation law are neither meaningless nor merely aspirational. Rather, they are legal rules intended to control behavior. In the area of loyalty, for example, the law's command to directors and officers is the standard of conduct, "deal fairly when you deal in your own self-interest," not the standard of review, "deal as you need to deal to get approval by your colleagues." Similarly, in the area of decision making the law's command is the standard of conduct, "act with due care," not the standard of review, "make decisions that cannot be characterized as irrational."

Moreover, the standards of conduct have a real bite. Although under certain conditions the elements of liability under a given standard of review may differ from the elements of liability under a linked standard of conduct, under other conditions the elements of liability will be the same. For example, a director who engages in a transaction with the corporation will be subject to a standard of review that is fully congruent with the applicable standard of conduct if he either fails to get approval by disinterested directors or shareholders or if such an approval is not proper. Similarly, a director who makes a disinterested decision will be subject to a due-care rather than a rationality standard of review if the requirements of the business-judgment rule are not satisfied. Accordingly, from the perspective of an actor proposing to engage in certain conduct, standards of conduct are "safe" rules and standards of review are "risky" rules. By this I mean that a director or officer who conforms his conduct to a standard of conduct knows that he is safe from liability in the absence of judicial error. In contrast, a director or officer who relies only on a standard of review that is less demanding than the parallel standard of conduct is at risk that the standard of review will be deemed inapplicable and liability will be imposed under the standard of conduct.

Finally, legal standards of conduct, containing messages sent by the legal system, also serve as a foundation for private standards of conduct, containing messages sent by the private sector. One characteristic private-sector form of message consists of legal advice: prudent lawyers who are asked to give advice to clients concerning a proposed course of action are likely to give advice based on the rules of conduct, not on the rules of review. A second important type of private-sector message in the corporate area consists of codes of conduct adopted by corporations and circulated to their employees: these codes too are usually based on legal standards of conduct, not on standards of review.

Granted that the standards of conduct in corporate law are meaningful legal rules, we are now brought to the question, what accounts for the pervasive divergence between those standards and the linked standards of review. In general, the answer to this question turns on the institutional nature of the corporation, but it is also heavily dependent upon the particular area in question.

In the area of the duty of care, for example, two kinds of explanation
can be proposed. One explanation is that the law wants to send directors and officers a two-part message, as follows: “Your legal duty is to act with due care. At the same time, we want to give you a certain amount of running room so that you are not unduly risk averse or otherwise preoccupied with liability. Therefore, liability will normally be imposed upon you only if there is a clear variance between the conduct required by due care and your actual conduct.” An alternative explanation—which is comparable to Dan-Cohen’s suggestion concerning the treatment of duress in criminal law—is that to maximize care, the law tells directors and officers to act with due care, while to take account of fairness (in particular, the difficulty of determining whether a business decision was reasonable), the law tells the courts to hold directors and officers liable for a bad judgment only if the judgment was either interested or in bad faith, the decision maker did not appropriately inform himself, or the judgment was so bad as to be irrational.

A somewhat different explanation applies to the area of loyalty. Unlike the duty of care, the divergence between the standards of conduct and review in the duty of loyalty comes into play only if the relevant conduct was approved by an independent organ. Accordingly, in this area corporate law is often concerned with two very different types of conduct: primary conduct, consisting of an action by a director or officer, and approving conduct, consisting of approval of that action by an independent corporate organ, such as the board or the shareholders. Therefore, the relevant standards may be explained on the basis that the law is sending one message to the primary actor and another message to the reviewing corporate organ. The message to the primary actor, which is relatively simple, is that he should follow the relevant standard of conduct. The message to the reviewing corporate organ, which is more complex, is as follows:

1. In deciding whether to approve the conduct of a primary actor, you should consider his action in light of the standard of conduct governing the duty of loyalty.
2. Furthermore, in deciding whether to approve his action you should conform your own action to the standard of conduct governing the duty of care.
3. Whether your approval is given effect will depend upon whether the primary actor’s conduct meets the relevant standard of review in light of your approval.

The two kinds of messages differ partly because the standards of review reflect two competing policies—respect for the corporation’s institutional autonomy, on the one hand, and concern whether the approving corporate organ is factually objective and fully informed, on the other.100

100. In theory, the law sends still a third message, to the courts, but in this context the content of that message will normally be congruent with the content of the message to the reviewing corporate organ.
A more general explanation for the divergence between standards of conduct and review in corporate law, which cuts across all areas, concerns differential knowledge of legal rules. Although it is common to assume that individuals act rationally on the basis of full information, in fact most actors make decisions on the basis of bounded rationality involving limited information. The standards of conduct in corporate law are for the most part directed to actors engaged in primary conduct. Such actors cannot be expected either to know all of corporate law or to consult a lawyer before taking every action. More especially, as a practical matter complex legal messages are likely to be unavailable to such actors, in the sense that such messages will tend to be either not heard, not understood, or not internalized. Accordingly, the legal messages that are primarily directed to such actors—that is, standards of conduct—should be simple, so that they can be effectively communicated, and to the extent possible should reflect social norms of upright business behavior that directors and officers can be expected to know even if they do not know the law.

In contrast, the standards of review in corporate law are directed primarily to judges, and secondarily to reviewing corporate organs. Judges either know the law or will be instructed in the law prior to making their decisions. A corporate organ that is called upon to review an action is in a position to become instructed in the law by counsel prior to making a decision. Accordingly, the standards of review may rest on social propositions other than norms of upright business behavior, and correspondingly may be formulated in a more complex manner than standards of conduct. These considerations apply with special force to actions to block tender offers, and decisions to reject a demand to bring a derivative action or to move that such an action be dismissed. The standards of review in these areas are often very complex. However, unlike ordinary-course business decisions, decisions by the board to institute a blocking action are normally taken only with the advice of counsel, because so much rides on such decisions. Decisions to reject a demand or move to dismiss a derivative action are also normally taken only with the advice of counsel, because they involve actual or threatened litigation. The predictable involvement of counsel in these types of decisions makes the complexity of the law in these areas acceptable.

Of course, the complex standards of review of corporate law will often be heard by, and will therefore affect the conduct of, primary actors. This possibility, however, does not defeat the force of a simplicity/complexity justification in the crafting of standards of conduct and standards of review. That justification does not turn on the desirability of keeping standards of review out of the hearing of primary actors. Rather, it turns on the desirability of reserving complexity in the law for those legal stan-

102. See id. at 386-87.
STANDARDS OF CONDUCT AND REVIEW

standards that are primarily addressed to actors that can deal with legal complexity in making their decisions. Nevertheless, in some areas the complexity of a standard of review may introduce a kind of partial acoustic separation, because a primary actor may be unable fully to internalize such a standard and understand its operation, and may therefore feel, and in fact be, safer if he operates only under the simpler standard of conduct. To the extent that the law wants primary actors to conform to the standard of conduct, rather than the standard of review, this partial acoustic separation will itself be desirable.

CONCLUSION

Despite the welter of standards in corporate law, certain organizing themes emerge. The standards of conduct are relatively simple. In all areas, directors and officers must act in good faith and in the interests of the corporation. In addition, where officers or directors are engaged in disinterested conduct they should act reasonably, and where they are engaged in self-interested conduct they should act fairly.

The standards of review are admittedly more complex, but essentially they fall into one of three levels—a very demanding level of review, a very relaxed level of review, and a level of review that is intermediate between those two extremes. The very demanding standards of review are good faith and pure fairness. The very relaxed standards of review are the business-judgment and waste tests. The intermediate standards of review are those applied to self-interested transactions that have been approved by disinterested directors, to blocking actions, to board action to prevent or terminate a derivative action based on conduct that would be itself reviewable under an intermediate or even more demanding standard, and to due-care cases that fall outside the ambit of the business-judgment rule. Although the intermediate standards applicable to each of these issues are formulated in a manner that reflects differences of nuance between the kinds of cases to which they apply, these differences should not be allowed to obscure the essential comparability of the various intermediate standards. Indeed, the emergence of these intermediate standards of review has been one of the major recent developments in corporate law.

Because lawyers tend to focus on the operational questions of liability and validity, it is easy to overlook the point that standards of review, which govern liability and validity, are not themselves standards of conduct. A director or officer who engages in self-interested conduct without having dealt fairly has acted wrongly, even though he is protected against liability by the relevant standard of review. A director or officer who makes an unreasonable decision has acted wrongly, even though he is protected against liability under the business-judgment rule. If directors or officers who violate the standards of reasonableness and fairness sometimes escape liability because of a less demanding standard of review, it is not because they have acted properly, but because utilizing
standards of review that were fully congruent with the relevant standards of conduct would impose greater costs than the costs of letting some persons who violated their standards of conduct escape liability. Such an officer or director may therefore be held accountable, even if not liable, for failure to meet the relevant standard of conduct.