THE CORPORATE DIRECTOR'S STANDARD OF CARE: PAST, PRESENT, AND FUTURE

By Krishnan Chittur*

I. Introduction

Corporate directors have always enjoyed the protection of the business judgment rule.[1] While rhetoric abounds regarding the standard of care to be met before this protection may be claimed,[2] rarely have individual directors been held liable.

The Delaware Supreme Court changed this situation by its decision in *Smith v. Van Gorkom*.[3] This article discusses that salutary development and some of its dimensions. Part I deals with the background and significance of the business judgment rule. Part II discusses the chimeric nature of its concomitant standard of care. Part III analyzes the *Trans Union* judgment and its precedents. Part IV considers the significance of *Trans Union* in corporate law. Part V discusses the current trend toward more active boards. Part VI postulates the decision's possible impact on the "primary purpose test," "outside" directors, and hostile takeovers. Part VII concludes that *Trans Union* is in accordance with contemporary thinking.

---

* S.J.D. candidate, Harvard Law School. LL.M. (1983 Harvard); LL.M. (1979 University of Bombay); LL.B. (1977 University of Bombay); B.S. (1974 University of Bombay); Ex-Professor of Law, Government Law College, Bombay.

The author would like to thank Professor Robert C. Clark, Harvard Law School, for his review of a draft of this article.

1. Corporate management is vested in the board of directors. If in the course of management, directors arrive at a decision within the corporation's powers (*intra vires*) and their authority, for which there is a reasonable basis, and they act in good faith, as a result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with the internal management and substitute its judgment for that of the directors to enjoin or set aside the transaction or to surcharge the directors for any resulting loss.

H. Henn & J. Alexander, Handbook of the Law of Corporations § 242 (2d ed. 1970). *See also* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 822-23 (1981) [hereinafter cited as Gilson].

2. *See* Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (N.Y. 1944) ("When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised.").

3. 488 A.2d 858, *reh'g denied*, 488 A.2d 858 (Del. 1985) [hereinafter referred to as *Trans Union*].

A. *The Significance of the Business Judgment Rule*

From the corporate perspective, the business judgment rule[4] enables management to articulate company policy and run its business without fear of personal liability.[5] Without this protection, the corporation would be unattractive to competent directors and officers. "[P]ersons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge."[6] If every board decision had to be reviewed on the merits, the corporation would become an impossibly slow runner in the fiercely competitive business world. In this sense, the rule seeks to avoid creating "incentives for overly cautious corporate decisions."[7]

From a systemic perspective, the rule is an institutional defense for the judiciary against invitations to venture into unfamiliar areas. Judges " *really* are not equipped by training or experience to make business judgments because such judgments are intuitive, geared to risk-taking and often reliant on shifting competitive and market

---

4. Some commentators have suggested a distinction between the business judgment rule and the business judgment doctrine: "The business judgment *rule* shields individual directors from liability for damages stemming from decision, whereas the business judgment *doctrine* protects the decision itself." J. Hinsey, *Business Judgment and the ALI's Corporate Governance Project: The Rule, the Doctrine, and the Reality,* 52 GEO. WASH. L. REV. 609, 611 (May-Aug. 1984). In other words, the *rule* is a personal defense but the *doctrine* is a corporate defense. Conceivably, the two are not coterminus: the rule could be much broader than the doctrine. This is because the two defenses would focus on different aspects—for example, the doctrine defense would focus on the cumulative awareness (information) of the board, while the rule defense would focus on individual awareness of the director. Courts could thereby reverse a corporate decision by flatly denying the doctrine defense instead of circumlocuting to reach the same result. The reluctance to impose liability (with the concomitant possibility for disastrous personal and financial consequences) on ill-paid and, therefore, ill-informed directors for sins of omission has caused such circumlocution. However, this rule/doctrine distinction is not part of existing law. Hinsey's failure to elaborate the elements and perimeters of either defense in this light scuttles his plea "to clarify this longstanding point of confusion." *Id.* at 618.

5. *See generally* Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?,* 37 BUS. LAW. 27, 32 (1981); Note, *Corporate Directors' Liability for Resisting an Offer: Proposed Substantive and Procedural Modifications of Existing State Fiduciary Standards,* 32 VAND. L. REV. 575, 589 (1979).

6. Arsht, *The Business Judgment Rule Revisited,* 8 HOFSTRA L. REV. 93, 97 (1979).

7. Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied sub nom.*, City Trust v. Joy, 460 U.S. 1051 (1983).

criteria."[8] In this sense, the rule is an integral part of judicial review in a society based on free enterprise, and helps to assure that the nation's businesses are not run from courtrooms.

From an individual perspective, the rule encourages entrepreneurs to take risks and venture into untested areas, spearheading economic growth. The investor who loses his money in this process assumes the risk of bad judgment "to a very real degree."[9] Given the option to diversify and reduce risk,[10] courts need not afford special protection to those who refuse to reduce the "volatility" of risk.[11]

Thus, there are a plethora of cogent reasons for the business judgment rule at all levels, macro and micro. Its singular legal significance is the immunity it confers on business decisions. If a board decision is protected by the rule, courts will not review the merits of that decision. "The legal standards of the 'business judgment rule' and the 'intrinsic fairness' test might be viewed as two extremes on a continuum."[12] The business judgment rule is the lower extreme of this continuum.

While the business judgment rule applies to both directors and officers,[13] this article considers it only as is applicable to corporate directors.

B. *The Common Law Standard*

The business judgment rule has been part of the common law for nearly two centuries.[14] It has proven to be a very potent defense for corporate directors and officers against claims primarily asserted by shareholders for loss resulting from decisions that went awry.

Conceivably, the rule's foundation is in tort law, in that direc-

---

8. *Id.* at 898 (Cardamone, J., dissenting).

9. *Id.*

10. *See generally* Wagner & Lau, *The Effect of Diversification on Risk*, 27 FIN. ANALYSTS J. 48 (Nov.-Dec. 1971); R. BREADLEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 114 (1981).

11. "Volatility" is the "degree of dispersion or variation of possible outcomes." D. KLEIN, BUSINESS ORGANIZATION AND FINANCE 147 (1980).

12. Nathan & Shapiro, *Legal Standards of Fairness of Merger Terms Under Delaware Law*, 2 DEL. J. CORP. L. 44, 44 n.5, 46 (1977).

13. Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Kelly v. Bell, 254 A.2d 62, 75 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. 1970).

14. Smith v. Pratville Manufacturing Co., 29 Ala. 503 (1857); Godbold v. Branch Bank, 11 Ala. 191 (1847); Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829); Hodges v. New England Screw Co., 1 R.I. 312 (1850).

tors' decisions were protected so long as they behaved reasonably. The rule thus incorporates the "reasonable man" standard to determine negligence. "The test of responsibility [is] not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the agent is of so gross a kind that a man of common sense, and ordinary attention would not have fallen into it."[15]

Liability was imposed with righteous indignation in cases that involved a conflict of interest (fraud or self-dealing, for example).[16] Even the possibility of self-dealing—as opposed to allegations of its actual occurrence—warrants closer judicial scrutiny. Thus, transactions between corporations having interlocking directorates are voidable[17] but to be set aside there must be a showing of fraud or unfairness.[18] The principal policy reason for this is to allay suspicion of "secret dealing in favor of one principal while acting as a representative of another."[19]

On the other hand, early cases were also influenced by the gratuitous nature of the directors' services.[20] Although Fletcher's seminal work suggests that "[l]iability . . . exists although they receive no compensation for their services,"[21] whether an unpaid director will be found liable initially depends upon whether that director's actions will be discovered at all.

II. THE STANDARD TODAY

A. *The Law in Books*

Twenty-eight states derive their directors' standard of care from common law.[22] In nine of these states, courts have not addressed

---

15. *Percy*, 8 Mart. (n.s.) at 78.

16. *E.g.*, Lewis v. S.L. & E, Inc., 629 F.2d 764 (2d Cir. 1980) (directors should have no conflict of interest before the rule can apply).

17. Bowman v. Gum, 327 Pa. 403 (1937).

18. Bonini v. Family Theatre Corp., 327 Pa. 273, 194 A. 498 (1937).

19. South Side Trust Co. of Pittsburgh v. Washington Tin Plate Co., 252 Pa. 237, 97 A. 450 (1916).

20. Briggs v. Spalding, 141 U.S. 132 (1891); Citizens Bldg. Ass'n v. Coriell, 34 N.J. Eq. 383 (1881); Spering's Appeal, 71 Pa. 11 (1872).

21. 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1031 (rev. perm. ed. 1975).

22. *See ALI, Principles of Corporate Governance: Analysis and Recommendations* 29 (Tent. Draft No. 4, 1985) [hereinafter cited as *ALI Draft*].

the issue at all; in several others, they "have not authoritatively addressed the issue."[23]

Courts which have considered the issue have formulated such diverse standards as (1) "care exercised by a prudent person in his own affairs,"[24] (2) "care that an ordinarily prudent person would exercise under similar circumstances,"[25] (3) "care,"[26] and (4) "due care."[27]

Twenty-two states have enacted statutory provisions defining the directors' standard of care. Of these, seven[28] have followed the standard promulgated in the Model Business Corporation Act.[29] Eleven others[30] require "care that an ordinarily prudent person would exercise in like position and under similar circumstances." While the

---

23. *Id.* at 41.

24. Alabama: Deal v. Johnson, 362 So.2d 214, 218 (Ala. 1978); Mississippi: Boyd v. Applewhite, 121 Miss. 879, 897, 84 So. 16, 23 (1920); Nebraska: Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 246 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973); Utah: FMA Acceptance Co. v. Leatherby Ins. Co., 594 P.2d 1332, 1334 (Utah 1979).

25. Arkansas: Johnson v. Coleman, 179 Ark. 1087, 1094, 20 S.W.2d 186, 188 (1929); Delaware: Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Kansas: Harman v. Willbern, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); Kentucky: Dunn's Adm'r v. Klye's Ex'r, 77 Ky. (14 Bush) 134, 147 (1878); Missouri: Heit v. Bixby, 276 F. Supp. 217 (E.D. Mo. 1967); Oregon: Devlin v. Moore, 64 Or. 433, 130 P. 35 (1913); Wisconsin: North Hudson Mut. Bldg. & Loan Ass'n v. Childs, 82 Wisc. 460, 476, 52 N.W. 600, 608 (1892).

26. New Hampshire: Charleston Boot & Shoe Co. v. Dunsmore, 60 N.H. 85 (1892).

27. Texas: Meyers v. Moody, 693 F.2d 1196 (5th Cir. 1982).

28. Connecticut: CONN. GEN. STAT. ANN. § 330313(d) (West Supp. 1980); Florida: FLA. STAT. ANN. §§ 607, 111(4) (West 1977); Hawaii: HAWAII REV. STAT. § 416-91.5(c) (Supp. 1979); Idaho: IDAHO CODE § 30-1-35 (1980); Indiana: IND. CODE ANN. § 23-1-2-11(2) (Burns Supp. 1980); Iowa: IOWA CODE ANN. § 496A.34 (West Supp. 1980); Maryland: MD. CORP. & ASS'NS CODE ANN. § 2-405.1(a)(3) (Supp. 1979).

29. The Model Business Corporation Act § 35 (1979) provides:

> A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

30. Louisiana: LA. REV. STAT. ANN. § 12:91 (West 1979); Maine: ME. REV. STAT. ANN. tit. 13-A, § 716 (1974); Massachusetts: MASS. ANN. LAWS ch. 156B, § 65 (Michie/Law. Co-op. 1979); Michigan: MICH. COMP. LAWS ANN. § 450.1541(1) (West 1973); Minnesota: MINN. STAT. ANN. 301.31 (West 1969); New York: N.Y. BUS. CORP. LAW § 717 (Consol. Supp. 1979); North Carolina: N.C. GEN. STAT. § 55-35 (1975); Oklahoma: OKLA. STAT. ANN. tit. 18, § 1.34 (West 1951); South Carolina: S.C. CODE ANN. § 33-13-150 (Law. Co-op. 1976); Tennessee: TENN.

remaining states use one of the above phraseologies,[31] California alone has a statutory requirement of "reasonable inquiry."[32]

A recent and much-cited article[33] contends that *Selheimer v. Manganese Corp. of America*[34] "represents the rare, if not the only, case in which the inclusion of a phrase such as 'in their personal business affairs' has been determinative of the outcome."[35] This contention stems from a misreading of *Selheimer*, as well as of other authorities.[36]

In *Selheimer*, the Pennsylvania Supreme Court distinguished the care exacted from the ordinary prudent man "in similar circumstances"[37] from that exacted from him "under similar circumstances in [his] personal business affairs."[38] After an extensive discussion of this distinction,[39] the court decided that "regardless of whether we follow the statutory rule or the rule enunciated in our case law prior to the statute, the same result follows in the case at bar."[40] The outcome in *Selheimer* did not turn on a difference between statutory and common law requirements; nor has this author found a case in which this difference in standards could lead to inconsistent results.[41]

B. *The Reality*

Seventeen years ago,[42] Professor Bishop contended that the director's duty of care was chimeric. In his famous article, he analyzed

---

CODE ANN. tit. 48-813 (1979); Wyoming: WYO. BUS. CORP. ANN. § 17-1-133(b) W.W.S. 1977 (1984 Cum. Supp.).

31. *See supra* text accompanying notes 24-27.

32. CAL. CORP. CODE § 309(a) (West 1977).

33. Veasey & Manning, *Codifed Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1979) [hereinafter cited as Veasey & Manning].

34. 423 Pa. 563, 224 A.2d 634 (1966).

35. Veasey & Manning, *supra* note 33, at 926-27 n.36.

36. *Id.* The authorities cited wrongly are Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 33 BAYLOR L. REV. 157, 163 (1970) ("no significant difference in outcome developed from the distinction"); and Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 371 (1965) ("no significant difference in result has appeared from the two formulations").

37. *See* Swentzel v. Pennsylvania Bank, 147 Pa. 140 (1892) (case law standard in Pennsylvania).

38. *See* PA. STAT. ANN. tit. 15, § 2852-408 (Purdon 1982).

39. *Selheimer*, 423 Pa. at 573-76, 224 A.2d at 640-43.

40. *Id.* at 579, 224 A.2d at 643.

41. On the Pennsylvania legislation amending the common law formulation, *see supra* note 38. Professor Lattin queries: "Is the legislature playing games with corporate counsel or the courts?" N. LATTIN, THE LAW OF CORPORATIONS 273 n.9 (1971) [hereinafter cited as LATTIN].

42. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of*

the precedents cited in this area, and concluded: "The search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a very small number of needles in a very large haystack . . . ."[43]

Professor Bishop found that most of the precedents involved banks or financial institutions. These cases displayed two common characteristics:

1. The recovery would probably benefit depositors (a class of creditors to whom the courts were particularly solicitous before federal deposit insurance), rather than shareholders; and

2. The directors were pathetically inattentive, warranting very strong rhetoric from the court.

In the context of other corporations,[44] a "small number of relatively recent cases . . . do seem to lend a modicum of substance to the fears of directors of industrial or mercantile corporations that they may be stuck for what they like to call 'mere' or 'honest' negligence."[45] Professor Bishop found four such cases. Two of these[46] held only that the plaintiff stated a cause of action in alleging director negligence. In the third[47] he found that "the facts are heavy with the odor of self-dealing."[48] Only in the fourth case[49] were the directors held legally liable for selling the assets of a liquidating corporation without adequate notice.

Professor Bishop concluded that directors ran little risk of liability for negligence. "There is, in fact, little precedent for liability even for the kind of Merovingian supineness for which directors were held liable in the old bank cases."[50]

Professor Bishop's article was a stellar contribution to increasing awareness of the problem of corporate accountability.[51] "Courts have

---

Corporate Directors and Officers, 77 YALE L.J. 1078 (1968) [hereinafter cited as Bishop]. A New York judge had suggested even earlier that "it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." Bayer v. Beran, 49 N.Y.S.2d 2, 6 (N.Y. Sup. Ct. 1944).

43. Bishop, *supra* note 42, at 1099.

44. Professor Bishop labelled these "industrial corporations." *Id.*

45. *Id.*

46. Clayton v. Vrish, 73 N.Y.S.2d 727 (N.Y. Sup. Ct. 1947); Syracuse Television, Inc. v. Channel 9, Syracuse, 273 N.Y.S.2d 16 (N.Y. Sup. Ct. 1966).

47. *Selheimer*, 423 Pa. at 563, 224 A.2d at 634.

48. Bishop, *supra* note 42, at 1100.

49. New York Credit Men's Adjustment Bureau v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953).

50. Bishop, *supra* note 42, at 1101.

51. *See generally* R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT

been far too lenient in their treatment of directors who do not direct under whatever rule they adopt as a test of liability."[52] Although perceptions of corporate directors' functions have changed since then,[53] this change has hardly been reflected in judicial thinking. Illustratively, as recently as 1981 the Ninth Circuit candidly suggested that "even a negligent decision to dismiss an action is legally dispositive, so long as it is made in good faith."[54]

Directors' complacence grounded on that state of affairs was rudely shaken for the first time by the epoch-making ruling in *Trans Union*.[55]

III. THE *TRANS UNION* DECISION

A. *The Judgment*

Trans Union involved the clandestine planning of the sale of Trans Union Corporation by Jerome Van Gorkom. The board acquiesced in his decision which was subsequently approved by the shareholders. The Delaware Supreme Court held that the board's action was negligent, and the shareholders' approval was inconsequential for want of adequate disclosure.

Jerome Van Gorkom assembled a financial structure whereby Trans Union could be bought at $55 per share in a leveraged buyout, with the debt therefrom cleared in five years by its own cash flow. On September 13, 1980, he sought to interest Mr. Pritzker in the idea. On September 18, Mr. Pritzker made an offer to buy on these terms, and Jerome Van Gorkom's suggestion subsequently became the Pritzker proposal. Pritzker would also buy 1.75 million shares of Trans Union at $38 each,[56] so that if a better offer was made, his efforts would still be rewarded.

Pritzker required an answer from the Trans Union board before September 21. Accordingly, in two successive meetings held on Sep-

---

CORPORATION (1977); C. STONE, WHERE THE LAW ENDS (1976); P. SETHI, UP AGAINST THE CORPORATE WALL (1981).

52. LATTIN, *supra* note 41, at 274.

53. *See infra* text accompanying notes 151-182.

54. Gaines v. Haughton, 645 F.2d 761, 772 (9th Cir. 1981). This case involved the dismissal of a derivative suit based on the decision of a special committee of directors appointed by the board. *See generally* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (discussing special committees of outside directors vis-a-vis dismissal of derivative suits).

55. 488 A.2d 858 (Del. 1985).

56. Seventy-five cents above the market price. *Id.* at 867.

tember 20 (on short notice and without prior intimation about its purpose), Jerome Van Gorkom apprised the senior management, and thereafter the board of directors of this proposal. Senior management vehemently opposed the offer, but the board approved it within two hours with little questioning.

Jerome Van Gorkom had been the chief executive officer of Trans Union for seventeen years, and then chairman of its board for two years. Additionally, he owned 75,000 shares of the company which he was willing to sell at $55 each. Obviously, the board fully relied upon his recommendation.

In response to widespread dissatisfaction among the management, Pritzker modified his proposal to enable Trans Union to solicit competing offers. He also agreed to extend the date of Trans Union's shareholder meeting to approve the transaction (originally scheduled for early January) to February 10, 1981. These modifications would enable Trans Union to obtain a better offer.

In effect, however, the amendments circumscribed Trans Union's options in two ways: (1) Trans Union could terminate the deal with Pritzker only if a deal with someone else had been consummated at a higher price before the stockholders' meeting; and (2) the extension of time for soliciting other bids was negated by time constraints imposed on Trans Union's response to Pritzker's proposal. The preliminary proxy statement was to be filed by December 5, 1980, and mailed to the shareholders by January 5, 1981. Obviously, the Trans Union Board would have to take a stand on the proposal in the proxy statement.

The board approved the modifications on October 8. On October 9, Pritzker purchased one million shares of Trans Union at $38 per share pursuant to the original agreement.[57] The amendments were executed on October 10.

The class action suit was filed on December 19, 1980. Discovery proceedings disclosed a considerable amount of information by the next board meeting on January 26, 1981.

In that meeting, the board's options were limited to endorsing the proposal or rescinding it (and risking a breach of contract suit by Pritzker). After considering other options not legally feasible, the board endorsed the proposal. The share holders accepted the proposal at the February 10 meeting.[58]

---

57. *Id.* at 870.
58. 69.9% voted in favor, 7.25% against, and 22.85% abstained. *Id.*

After an exhaustive review of the evidence, the Delaware Supreme Court disagreed with the trial court. It found that the board was not protected by the business judgment rule because its decisions on the Pritzker proposal were "uninformed."

Jerome Van Gorkom's oral presentation was not a "report" on which the directors could rely.[59] This was because Van Gorkom himself was "basically uninformed" about the document[60] he was asking the board to approve. Under the circumstances (i.e., absence of any urgency and lack of proper notice or information), the board should have asked in-depth questions. The directors, therefore, "at a minimum, were grossly negligent."[61]

The directors did not inform themselves of the "intrinsic value" of the company; the sixty-two percent premium over the average market price did not per se justify reliance. Jerome Van Gorkom had suggested the price of $55 solely on the basis of economic feasibility of a leveraged buy-out.[62] The court stated: "Apart from the Company's historic stock market price and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company."[63] Since this material information, *inter alia*, was not disclosed to the shareholders in the proxy materials, shareholder approval of Pritzker's proposal failed to have any curative effect.

The court failed to differentiate between "inside" and "outside" directors. Thus the standard of care is arguably the same for both types under this decision.

The five outside directors were eminent personalities in the business world. This group included: (1) Dr. Wallis, a professor of Economics at Yale and dean of the Graduate School of Business at the University of Chicago, chancellor of the University of Rochester, and member of the board of several large corporations such as Bausch

---

59. *See* DEL. CODE ANN. tit. 8, § 141(e) (1983).

60. *Trans Union*, 488 A.2d at 875.

61. *Id.* at 865, 874.

62. It is not clear whether the court would require the board to consider alternative methods of structuring the deal, in addition to knowing the "intrinsic value" of the company. For example, a leveraged buy-out itself may be structured in many ways: cash-out mergers; sale of assets and liquidation; sale of assets, issuer cash tender offer and conversion to investment company; or subsidiary merger, sale of stock, and liquidation. *See generally* Kaufman, Lang, Ley & Messineo, *Leveraged Buy-Outs and Other Asset-Oriented Transactions* in 395 ACQUISITIONS & MERGERS 1982: Recent Developments and Techniques 55-56 (PLI 1982).

63. *Trans Union*, 488 A.2d at 866 (footnote omitted).

& Lomb and Kodak;[64] (2) Mr. William Johnson, the chairman and chief executive of I.C. Industries Holding Co.;[65] (3) Mr. Joseph Lanterman, a certified public accountant, president and chief executive officer of American Steel and a member of the boards of several large corporations such as International Harvester and Harris Bank & Trust Co.;[66] (4) Mr. Graham Morgan, chairman and chief executive officer of U.S. Gypsum who had been involved in thirty-one corporate takeovers over a period of seventeen years; and (5) Mr. Reneker, president and chief executive officer of Swift & Co. and member of the boards of seven other reputable corporations.[67]

"The five 'outside' directors totaled seventy-eight years of combined experience as chief executive officers, and *fifty-three years cumulative service as Trans Union directors.*"[68]

The other five directors were "insiders," with "their badge of expertise in the corporate affairs of Trans Union on their sleeves."[69]

Quite understandably, the dissent focused on the personalities and qualifications of the directors involved. "These men knew Trans Union like the back of their hands and were more than well qualified to make on the spot informed business judgments concerning the affairs of Trans Union including a 100% sale of the corporation."[70]

This appears to be the crux of the difference of opinion. In the majority view, no matter *who* the directors are, or for how long they have been involved with the corporation, they should not approve a merger without availing themselves of adequate information. "The directors' unfounded reliance on both the premium and the market test as the basis for accepting the Pritzker proposal undermines the defendants' remaining contention that the Board's collective experience and sophistication was a sufficient basis for finding that it reached its . . . decision with informed, reasonable deliberation."[71]

It is arguable that the ruling turned on the additional responsibilities specifically cast on directors by statute in cases of merger. Under Delaware law,[72] the board's action had to be "informed and deliberate" in responding to a merger proposal. However, such a

---

64. Also a Trans Union Director since 1962. *Id.* at 894 n.3.
65. Also a Trans Union Director since 1968. *Id.*
66. Also a Trans Union Director since 1980. *Id.*
67. Also a Trans Union Director since 1971. *Id.*
68. *Id.* (emphasis added) (McNeilly, J., dissenting).
69. *Id.*
70. *Trans Union*, 488 A.2d at 895 (McNeilly, J., dissenting).
71. *Id.* at 880.
72. DEL. CODE ANN. tit. 8, § 251(b) (1983).

restrictive interpretation is implausible for three reasons. First, "deliberate" adds nothing to the "informed" decisions normally required of directors. It is difficult to imagine a decision that is "informed" but not deliberate. That distinction seems to be tailor-made for academic ecstasy. Second, the court did not dwell on the distinction at all. In fact, reliance on a wide variety of cases strongly suggests the contrary: that the ruling is intended to have a wide application. Third, the decision is based on a common law, *a priori* approach, rather than one of statutory construction. The court stated: "Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here."[73]

B. *The Precedents*

Backed by a plethora of citations, the *Trans Union* court would have its readers believe that it was simply following existing law. Of course, this is understandable. The court's appeal to precedent is an institutional defense against illegitimacy in a political democracy.[74] A closer scrutiny of the cases, however, reveals that, *at a minimum, Trans Union* establishes that the earlier saber-rattling[75] was not in vain.

The laudatory reference[76] to the *Pogostin v. Rice*[77] board was well deserved. In that case, Tamco Enterprises, Inc. made a tender offer for City Investing Co. at $32.50 per share.[78] A derivative suit was dismissed for not making the statutory demand on the board to pursue the corporate claim, or alleging with particularity that demand was futile.[79]

City's board consisted of four "insiders" and ten "outsiders." The board appointed a special committee composed entirely of outside directors to consider the offer. That committee hired two reputable investment banking firms who analyzed the company and the offer

---

73. *Trans Union*, 488 A.2d at 872.

74. *See generally* R. COVER & O. FISS, THE STRUCTURE OF PROCEDURE (1979).

75. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[T]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.").

76. *Trans Union*, 488 A.2d at 878 n.20.

77. 480 A.2d 619 (Del. 1984).

78. At that time, the shares were trading at about $20 per share. *Id.* at 622.

79. DEL. CH. CT. R. 23.1.

over a period of one month. Thereafter, the committee reported (presumably based on the opinion of the investment bankers) that the company's shares were worth $48 per share. After extensive discussion, the board unanimously rejected the offer. The Delaware Supreme Court was "not persuaded by plaintiff's claim that the City board's refusal to accept the premium offered by Tamco, or to negotiate with Tamco under these circumstances, [were] prima facie breaches of fiduciary duties . . . ."[80]

It is difficult to evaluate the precedential value of *Mitchell v. Highland-Western Glass Co.*[81] In addition to being a trial court opinion, the case did not involve the directors' lack of inquiry; in fact, the grouping of directors and officers together strongly suggests that it was not an omission on the part of the *directors* that was specifically alleged. Moreover, the exact extent of the board's involvement is unclear from the court's opinion. The chancellor noted:

> [T]he evidence is very clear to the effect that the books of the Mississippi Glass Company, the purchaser, had been fully opened up to the defendant and its affairs exposed to the inspection of the defendant's directors. I can find no justification in the evidence for concluding that the defendant's directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment.[82]

However, the *Trans Union* court's reliance on *Gimbel v. Signal Cos.*[83] is misplaced. While the facts are as summarized in the judgment, the injunction was issued on grounds apparently unrelated to the business judgment rule.

In *Gimbel*, the plaintiff challenged the impending sale of all outstanding common stock of Signal Oil & Gas Co. (a wholly owned subsidiary of Signal Cos., Inc.) to Burmah Oil, Inc. Of Signal's fourteen directors, twelve attended the meeting when the sale was approved. Of these twelve, four were directly involved in Signal's management: one was the president of the subsidiary being sold, two were from the management of other subsidiaries, and one was the companies' outside attorney. Four directors were total outsiders:

---

80. *Pogostin*, 480 A.2d at 627.
81. 167 A. 831 (Del. Ch. 1933).
82. *Id.* at 833.
83. 316 A.2d 599 (Del. Ch. 1974), *aff'd per curiam*, 316 A.2d 619 (Del. 1974).

one was a retired banker with experience in the oil industry; one was the dean of the School of Management, UCLA; one was a businessman with over twenty-five years' experience in oil investment; and one was the president of a theatrical and television lighting company.

As in *Trans Union*, the Delaware Chancery Court was impressed with the qualifications of the individual directors.[84] The extent to which these directors were "informed" is, however, seriously questionable. The transaction with Burmah Oil had been in progress since October. Although the Signal management had decided very early to recommend the transaction to the board, the directors were not informed. Management, however, went "out of its way" to relieve anxiety among employees of the subsidiary being sold but made no effort to educate the board. The plaintiff, the largest shareholder, learned of the impending sale and communicated his opposition to the directors. He also contended that shareholder approval was required for the transaction. The Signal management's only response was to obtain legal advice which confirmed the board's power to sell without shareholder approval.

Burmah Oil made a firm offer on December 18 and demanded an answer by the 21st. The Signal management made no effort to seek an extension of the deadline but called a board meeting on two days' notice to approve a transaction involving $480 million. The Signal board's response to the offer was deficient in three major respects. First, six of the twelve directors who attended the meeting were unaware of the purpose of the meeting beforehand. That their judgment was "uninformed" is, therefore, not even disputable. Second, there had been extreme fluctuations in the oil market. Signal had last been valued in September, and this valuation was the basis of Burmah's offer. Therefore, a drastic change in value was quite likely. The court euphemistically suggested that "the situation made desirable an updated evaluation."[85] Third, Signal needed cash. The directors were, hence, "understandably fearful" of challenging the time constraints imposed by Burmah. However, the board had "no precise analysis" about how the sale money was to be utilized. Income projections showed a decrease after the sale, compared to the projections before the sale. Simply put, Signal wanted money, but did not know for what purpose.

---

84. *Id.* at 613 ("a sophisticated one and one which experience and background would compare favorably to Boards of Directors of similar corporations").

85. *Id.*

Despite these *observed* deficiencies, the leap to the business judgment rule was not interrupted:

> The factors, which suggest imprudence and *perhaps some others* . . . do not in my judgment raise at this stage a reasonable probability that the plaintiff will be able to pierce the "business judgment" standard. When considered in light of the whole case, they do not in themselves justify the conclusion that the "directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment."[86]

Rather than holding that the pathetic lack of information vitiated the decision to sell (as in *Trans Union*), the court went on to consider the merits:

> [T]he full circumstances surrounding the approval do relate to the overriding factual issue in the case. What was Signal Oil worth on December 21, 1974? Or to put the question in its legal context, did the Signal directors act without the bounds of reason . . . ?
>
> ———
>
> Thus, the ultimate question is not one of method but one of value.[87]

The *Gimbel* ruling was, thus, an invitation to the precise type of conduct condemned in *Trans Union*. The long-standing relationship of Jerome Van Gorkom and the board to Trans Union made their decision that much more informed.

The injunction in *Gimbel* was predicated on other grounds. The trouble lay with the grossly inconsistent expert opinion on valuation. Signal's expert valued the company at $438 million toward the purchase price of $480 million, while plaintiff's expert valued it at $761 million.[88] Either side would thus suffer "irreparable injury" if the interlocutory ruling went against it. Plaintiff's estimated damages of $300 million on denial of the injunction was counterpoised by Signal's loss of $220 million on its issuance.[89] Neither side could be adequately compensated by the other in the event of a subsequent victory if defeated at the interlocutory stage. The court, therefore, granted an injunction conditioned on plaintiff's posting a bond for

86. *Id.* at 615 (citing *Mitchell*, 167 A. at 833).
87. *Id.*
88. *Id.* at 616.

$25 million. The sale would be restrained until February 15, and trial "solely on the issue of evaluation"[90] was set for January 23.

Therefore, the *Gimbel* decision was apparently not based upon the business judgment rule. It was exclusively an appraisal question with the interim injunction and the expedited trial reflecting the "irreparable injury" that could occur to either side.[91] The Delaware Supreme Court found no abuse of discretion and affirmed the decision[92] on February 7, 1974.

To be sure, the *Gimbel* court could and should have reasoned more directly to the same end and denied the business judgment defense. The law applicable in such situations appears clear, self-evident, and stale with repetition:

> If . . . it is found that the board acted with due care, the price will be irrelevant. If, on the other hand, it is found that the board did not act in an informed manner, then the question of price becomes critical because if the price is found to be fair, the transaction must be upheld regardless of how the board made its decision.[93]

To suggest that the Signal board acted with due care while proceeding to review the merits of the decision is to do *precisely* that which the business judgment rule was meant to forestall: second guess business decisions that were properly taken. Conceptual confusion of this variety has been responsible for much uncertainty in this area of the law.

Perhaps it is significant that, unlike *Gimbel*, the *Trans Union* facts display *elements* of managerial autocracy and misconduct. The board and the senior management were not a unified voice in *Trans Union.* Senior management was against the proposal almost in toto.[94] Jerome Van Gorkom's conduct could have piqued the court; his discouragement of better offers (or even the search for competing offers),

---

89. *Id.* at 603-04.

90. *Id.* at 618.

91. *Id.* at 604 ("[W]hen the plaintiff claims with expert support, a potential damage in the neighborhood of $300 million, it is doubtful that any damage claim against the directors can reasonably be a meaningful alternative." *Id.*).

92. *Id.* at 619.

93. Weinberger v. United Fin. Corp. of Cal., No. 5915, slip op. at 21 (Del. Ch. Oct. 13, 1983).

94. Only Chelberg (president and CEO) and Peterson (controller) amongst the entire senior management supported Van Gorkom's proposal. *See Trans Union*, 488 A.2d at 867.

fast shuffling,[95] suppressing information except as to the bare essentials, and—most suspiciously—refusal to produce the merger agreement at trial (which led to the inevitable adverse inference from the court),[96] all indicate that he wanted the proposal confirmed at any cost.

Whether these factors actually had any influence on the court's ultimate decision in *Trans Union* is speculative. Of course, they were totally irrelevant to the central issue under consideration—whether the directors' decision was informed. But the gratuitous mention of such facts[97] *ipso facto* suggests that they had a prejudicial effect. Concededly, however, *Trans Union* cannot be fairly interpreted to have been *decided* on these grounds. The *ratio decidendi*[98] is, thus, that *Gimbel* has been overruled.[99]

IV. THE SIGNIFICANCE OF *TRANS UNION*

A. *The Novelty*

That *Trans Union* is a ripple in the directors' sea of tranquility is clear. It is also a precedent-setting contribution to the law in three respects.

First, it illustrates the director's standard of care *precisely* and authoritatively. Delaware courts had previously formulated this standard in various terms. Prior decisions had spoken of "fraud or gross overreaching,"[100] "gross and palpable overreaching,"[101] "bad faith . . . or a gross abuse of discretion,"[102] "fraud or abuse of discretion,"[103] "grossly negligent,"[104] and "reckless indifference to or de-

95. *See id.* at 894 (McNeilly, J., dissenting).

96. *Id.* at 878.

97. *See id.* at 866 ("It is noteworthy in this connection that he [Van Gorkom] was then approaching 65 years of age and mandatory retirement."). The significance of this is also unclear. Van Gorkom could easily have secured a waiver of the "mandatory retirement" for himself, considering his influence on the board.

98. The *ratio decidendi* ought to be found by focusing on what the court *did* rather than on what it *said*. *See* J. FRANK, COURTS ON TRIAL 265-67 (1950).

99. For an interpretation of *Gimbel* in accord with this contention, see E. BRODSKY & M. ADAMSKI, CORPORATE OFFICERS AND DIRECTORS § 2.09 nn.18-22 (1984).

100. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971).

101. Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970).

102. Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966).

103. Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963).

104. Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972). But this court spoke in terms of *fiduciary* duty: "[D]irectors may breach their fiduciary duty . . . by being grossly negligent." *Id.*

liberate disregard of the stockholders."[105] Only recently[106] was "gross negligence" established as the governing standard. While that phrase has long been criticized as not particularly enlightening,[107] *Trans Union* illustrates the standard of care didactically.

Surely, there have always been guideposts for determining this standard. State statutes provide protection for good faith reliance by a director on an officer's report.[108] In the absence of statutory protection, reliance is relevant in finding due care.[109] Similarly, the board may place reliance upon counsel but only for strictly legal issues.[110]

It has also been settled that such reliance is not an absolute defense: it must be warranted,[111] as *Trans Union* clarified. Thus, where the information is supplied by an employee who has a personal stake in the matter, more verification would be required.[112] However, if the reliance is justified, the board is protected even if the advice is wrong.[113]

These guideposts were, however, in the nature of *obiter dicta*, offered as illustrations of what *ought* (or ought not) to be negligence. *Trans Union* has captured the hitherto elusive genie called director's negligence.

Second, *Trans Union* is the first case to impose liability on directors for the lack of reasonable inquiry. Hitherto, the cases holding directors liable involved a deplorable lack of *attention*. Even if Professor Bishop's classification is disregarded,[114] since "[n]o sensible distinc-

---

105. Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929).

106. *Aronson*, 473 A.2d at 812.

107. *E.g.*, Wilson v. Brett, 152 Eng. Rep. 737, 739 (1843) (gross negligence is merely negligence "with a vituperative epithet"). *See also* Grill v. General Iron Screw Collier Co., 35 L.R.C.P. 321 (1866).

108. *E.g.*, CAL. CORP. CODE § 309(b) (West 1977); DEL. CODE ANN. tit. 8, § 141(c) (1983); N.Y. Bus. Corp. Law § 717 (McKinney 1985); MONT. CODE ANN. § 35-1-401(3)(a) (1983); MINN. STAT. ANN. § 302A.251, subd. 2 (West 1985).

109. Gilbert v. Burnside, 13 A.D.2d 982, 983, 216 N.Y.S.2d 430, 432 (N.Y. App. Div. 1961), *aff'd*, 11 N.Y.2d 960, 229 N.Y.S.2d 10, 183 N.E.2d 315 (1962).

110. Glassberg v. Boyd, 116 A.2d 711, 719 (1955). *See generally* Hawes & Sherard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 49 (1976).

111. Heit v. Bixby, 276 F. Supp. 217, 231 (E.D. Mo. 1967).

112. Barr v. Wackman, 36 N.Y.2d 371, 368 N.Y.S.2d 497 (1975). *See generally* Cary & Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61 (1972).

113. Tannenbaum v. Zeller, 399 F. Supp. 945, 955 (S.D.N.Y. 1975), *aff'd in part and rev'd on other grounds*, 552 F.2d 402 (2d Cir. 1977), *cert. denied*, 434 U.S. 934 (1977).

114. *See supra* note 43 and accompanying text.

tion can be drawn on the basis of the label 'financial' as opposed to 'industrial' corporation,"[115] *Trans Union* is still a first.

While the earlier precedent[116] can also be characterized as "lack of reasonable inquiry" cases, *Trans Union* cannot be characterized as a "lack of attention" case. The Trans Union directors were exceptionally qualified businessmen, attentive to corporate affairs, knew Trans Union "like the back of their hands,"[117] but did not make reasonable inquiry on one particular, impugned decision. "All members of the board were well-informed about the company and its operations as a going concern."[118] The same cannot be said of the other cases.[119]

The concept of attention certainly includes *some* minimal inquiry. Thus, a director who attends meetings, listens with care to the material presented therein, and reads the documents presented to him (or at least the summaries or substances) is not lacking in attention. Perfunctory inquiries can be expected of him; they clarify his understanding. The cases in which directors have been found liable, absent fraud or self-dealing, fall in the category "lack of attention."

Thus, in *DePinto v. Provident Security Life Insurance Co.*,[120] a physician became a director of an insurance company in 1955 at a friend's request. The physician was so uninformed about the company that he did not even know that it had sustained losses in 1955, 1956, and 1957. He falsely signed attendance in meetings from which he was absent; in those at which he was present, he signed minutes without reading them. He did not know the officers of the company or even when the president of the company resigned. He was instrumental in approving the transfer of the company to the valueless company, and the jury found him liable for negligence. Even minimal attention to the corporation would have made him aware, "so that he should have investigated the proposal."[121]

Similarly, in *Heit v. Bixby*,[122] directors were held liable for secret

---

115. *ALI Draft, supra* note 22, at 42.

116. *E.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied sub nom.*, City Trust v. Joy, 460 U.S. 1051 (1983).

117. *Trans Union*, 488 A.2d at 895 (McNeilly, J., dissenting).

118. *Id.* at 868.

119. *E.g.*, Lutz v. Boas, 171 A.2d 381, 396 (Del. Ch. 1961) ("[E]ven an average attention to duty by the directors would have revealed" the impugned misconduct.).

120. 374 F.2d 37 (9th Cir. 1967).

121. *Id.* at 43-44.

122. 276 F. Supp. 217 (E.D. Mo. 1967).

commissions received from corporate business. The nonprofitting directors' "token management . . . amounted to little more than a scanning of [the] proxy statements."[123] Characterizing their attitude as one of "absolute indifference,"[124] the court held the directors' reliance on the apparent trustworthiness of their colleagues was no defense. With this background, it is hardly surprising that the corporate bar has viewed the decision with alarm.[125]

Third, *Trans Union* is the first comprehensive analysis of the *causal nexus* required in attaching director liability. The legal analyses in the earlier cases were obviously influenced by their fact-patterns and had left this element unclear. This occured because courts had "inanely mix[ed] value-neutral cause-in-fact (*who did it*) with the policy matter of allocating accident costs (*who should pay*)."[126]

The directors in the earlier cases can be classified as absentee directors,[127] ornamental directors,[128] or spectator directors.[129] Judicial pronouncements on causation were thus geared to those characteristics. In some cases, courts required proof that if the defendant-director "had done his full duty, he could have made the company prosper, or at least could have broken its fall. He must show what sum he could have saved the company." In the context of those cases, this was an impossible hurdle for the plaintiff.[130] In still other cases, courts discussed the usually inadmissible[131] "pattern of con-

---

123. *Id.* at 231.

124. *Id.*

125. After all, that section of the profession "is, and has consistently been, the confidant, advocate and friend of corporate management." Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 204 (1979). *See* Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW 1, 1 (1985) [hereinafter cited as Manning].

126. Vinson, *Proximate Cause Should Be Prohibited From Wandering Outside Negligence Law*, 13 FLA ST. U. L. REV. 215, 215 (1985).

127. This group comprises of those who do not even bother attending board meetings. *E.g.*, Bowerman v. Hammer, 250 U.S. 504 (1919).

128. This group includes those who do not bother getting acquainted with the corporate business so that even their attendance is ornamental. *E.g.*, Barnes v. Andrews, 298 F. 614 (D.N.Y. 1924); DePinto v. Provident Sec. Life Ins. Co., 374 F.2d 37 (9th Cir. 1967).

129. This includes those who sat silently through board meetings in the face of evidently gross mismanagement or fraud. *E.g.*, Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938).

130. *Barnes*, 298 F. at 617. *Accord* Murphy v. Hanlon, 322 Mass. 683, 79 N.E.2d 292 (1948).

131. *See* 1 A J. WIGMORE, EVIDENCE § 65 (Tillers rev. 1983); Central Vt. Ry. Ruggles, 75 F. 953 (1st Cir. 1896) (watchman's habit inadmissible to show specific

duct,"[132] leaving muddied waters on *causal nexus*. *Trans Union's* focus on the process of directorial decision-making[133] was, thus, illuminating.

However, the court's extensive attention to the facts is somewhat bothersome. It is true that the reiteration of the minutiae has met with approval from some quarters. One commentary, in fact, hailed it as a "virtual road-map for counsel called upon to advise a corporate board about major corporate transactions."[134] That is likely to be a mixed blessing.

The predominantly factual orientation of the decision makes the facts on which the case turns elusive. A factual distinction from precedents is very easy to draw; that is the basis of the whole legal profession.[135] Interpretation of *Trans Union* could conceivably result in a wrangle for distinguishing facts.[136]

Thus, *Trans Union* could become a lawyers' paradise. Its misreading of precedents without overruling them explicitly only accentuates this likelihood. Quite understandably, the bar has gleefully greeted the ruling as tending to "bolster the practice of many major law firms of [sic] involving litigators as well as corporate attorneys

---

failure of duty); Harriman v. Pullman Palace Car Co., 85 F. 353 (8th Cir. 1898) (careful habits of employee inadmissible); Arizona & N.M. Ry. v. Clark, 207 F. 817, 823 (9th Cir. 1913), *aff'd*, 235 U.S. 669 (1915); Reyes v. Missouri Pac. R.R., 589 F.2d 791 (5th Cir. 1979) ("Rule 404 of the Federal Rules of Evidence embodies the well-settled principle that evidence of a person's character is not admissible for the purpose of proving that the person acted in conformity with his character on a particular occasion.").

132. *E.g.*, Lynch v. Patterson, Nos. 84-185, 84-186 (Wyo. June 14, 1985) (Rose, J., & Thomas, C.J., dissenting) ("While any one of these . . . actions might not be sufficient to hold a director liable, the *complete pattern of conduct* evidence a program of corporate destruction and violates the duty of care."). The majority held that where corporate opportunity was appropriated by directors wrongfully, the profiting directors should compensate the victims. The dissent would require that the wife-director, who did not profit, should also be liable for this compensation since she violated her duty of care as a director. The majority did not discuss this issue of *causal nexus*.

133. *See* Schwartz & Wiles, *Business Judgment Rule Clarified by Delaware's Trans Union Decision*, NAT'L L.J., Jul. 8, 1985, at 42, col. 3 [hereinafter cited as Schwartz & Wiles].

134. *Id.* at 45, col. 1.

135. *See* J. FRANK, COURTS ON TRIAL 277 (1950) ("[A]ble lawyers often disagree concerning the portions of opinion which are dicta. What one judge calls the 'true rule' employed in a decision, another judge may describe as dictum.").

136. For an illustrative example categorizing facts as falling on the "approved" side or "disapproved" side by implication from *Trans Union dicta*, *see* Manning, *supra* note 125, at 8-14. It is doubtful, however, that that categorization will find much acceptance from plaintiff lawyers.

. . . ."[137] The implication is that henceforth directors would do better than to approve a $690 million deal in two hours.

B. *The Influence*

It is premature to visualize how *Trans Union* will fare in the field of corporate law generally. Delaware has traditionally enjoyed a preeminent position in this area.[138] In proclaiming its victory in the "race to the bottom" a decade ago, Professor Cary said the unsayable: "Perhaps there is no public policy left in Delaware corporate law except the objective of raising revenue."[139]

This perception has not been restricted to the law review commentaries. The Fifth Circuit (among others) has refused to enforce Delaware law even when warranted under Conflict of Laws principles.[140] That court justified its refusal by citing other courts that had acted similarly "in order to escape the inequitable rule of the forum (generally Delaware)."[141]

Certainly, several others have sprung to Delaware's defense. One commentator suggested that Professor Cary's analysis was "biased, unscholarly and wholly unfair. If his articles had to measure up to the required standards of an SEC disclosure statement, they would be found woefully deficient."[142]

Without addressing the merits of that controversy,[143] the important point is that it illustrates Delaware's trend-setting position in corporate law—*primus inter pares*. Business Week, that authoritative voice of corporate America, described the Delaware Supreme Court

---

137. Schwartz & Wiles, *supra* note 133, at 46, col. 1.

138. As of Dec. 28, 1984, over 43% (660 out of 1,525) of the corporations listed on the New York Stock Exchange were incorporated in Delaware. *See* NYSE Guide (CCH) 725-99 (1984).

139. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 672 (1974) [hereinafter cited as Cary]. "The view is widely held that Delaware corporate decisions lean toward the status quo and adhere to minimal standards of director responsibility both to the corporation and its shareholders." For a similar view, see R. NADER, M. GREEN & J. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION 51-70 (1976) [hereinafter cited as NADER].

140. Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959).

141. *Id.* at 322.

142. Arsht, *A Reply to Professor Cary*, 31 BUS. LAW. 1113 (1976).

143. *See generally* ALI, *Commentaries on Corporate Governance and Structure* (D. Schwartz ed. 1979).

as "[t]he tribunal that has the most influence on U.S. corporate legal issues."[144]

With the *Trans Union* decision, Delaware has confounded its critics by signaling that the "race to the bottom" is over. At the least, Delaware is no longer the winner.

Thus far, the four reported cases which have relied on *Trans Union* hardly suggest a trend. One, however, merits closer scrutiny as it indicates that Delaware might be substituted quickly in the "race to the bottom."

In *Repairman's Service Corp. v. National Intergroup, Inc.*,[145] National Intergroup merged with Bergen National Corp., a subsidiary of Bergen Brunswig Corporation. The directors had been kept informed of the negotiations. Bergen's desirability as a merger partner was considered in depth at an early stage of the negotiations. In fact, at one point, the talks were on the "edge of abandonment."

Ten of the fourteen directors were "outsiders." The business judgment rule was thus fully applicable. Consequently the plaintiff's request for a preliminary injunction was rejected. Although *Trans Union* was cited, it cannot be viewed as controlling in the decision.

The second case, *P. Allison v. General Motors Corp.*,[146] involved a derivative suit that sought recovery of damages suffered by the corporation due to defective brakes. The Delaware district court upheld the directors' decision to terminate the suit.

The plaintiff attempted to overcome the business judgment rule on such grounds as the lack of independence and good faith on the part of the directors. However, he failed to "allege that the Board did not take the time or make the effort to inform itself."[147]

The third case, *Lynch v. Patterson*,[148] involved the misappropriation of corporate opportunities by directors for personal gain.

The references to *Trans Union* in the above decisions are, therefore, not very helpful. They give no indication of how those jurisdictions would interpret the decision.

The fourth decision, *Gries Sports Enterprises, Inc. v. Cleveland Browns*

---

144. *A Landmark Ruling that Puts Board Members in Peril*, Bus. Wk., Mar. 18, 1985, at 56.

145. No. 7811 (Del. Ch. Mar. 15, 1985).

146. 604 F. Supp. 1106 (D. Del. 1985).

147. *Id.* at 1113-14.

148. *Lynch*, Nos. 84-185, 84-186, slip op. at 5.

Football Co.,[149] is of particular interest. It involved the Cleveland Browns' acquisition of CSC in circumstances that "certainly bear a distinct resemblance to those discussed in [*Trans Union*]."[150]

Modell was 53% shareholder and president of the Cleveland Browns and an 80% shareholder and president of CSC. Gries was 43% shareholder in the Browns, and a very small shareholder in CSC. The remainder of the Brown's board of directors consisted of Modell's wife, Patricia; Bailey, the Brown's vice-president and general counsel; Cole, an officer of a travel agency of which the Browns owned 50%; and the plaintiff Gries. These same individuals, with the exception of Patricia Modell, comprised CSC's board of directors.

Modell wanted the Browns to acquire CSC. He also sought to become 100% owner of CSC, and offered to purchase the other shares. CSC offered to repurchase their shares for $120 each, rather than the $32 contractually stipulated. On March 2, 1982, all the minority shareholders tendered their shares making Modell the 100% shareholder. Bailey thus made $24,000; Berick, $60,000 (in addition to the $20-25,000 fees earned by his law firm for the deal); and Cole, $192,000. Soon thereafter (on March 16, 1982), the board approved the Browns' acquisition of CSC for $6 million. This was the *highest* appraisal of CSC, valued by McDonald at the behest of, and paid for by, CSC. Whether the board's decision was "informed" is quite questionable, as are other parts of the decision.[151]

The directors were told of this appraisal at their meeting of November 24, 1981. Gries was the only director who requested more time to study the report. He retained his own expert, who valued CSC at $2 million. In February 1982, Bailey commissioned a second appraisal, which concluded the land to be valued was worth $2 million less than the McDonald appraisal. Yet, at the March 16 meeting, the directors did not question the accuracy of McDonald's appraisal, and no one asked to see the Bailey appraisal.

With the exception of Gries, all the directors made money on the Browns' inflated acquisition. Bailey had arranged the financing for the deal. On April 24, 1981, without any evaluation, he expected a price of $5-7 million for CSC. While the Trans Union directors had no reason to suspect the information supplied by Jerome Van

149. Nos. 49184, 19197 (8th Cir. App., Cuyahoga, Ohio, Apr. 25, 1985).

150. *Id.* (Jackson, J., dissenting).

151. *See* Schein v. Caesar's World, Inc., 491 F.2d 17, 20 (1974) (It is "incumbent upon the corporate directors to evaluate the relative risks of alternative courses of action." This the Gries directors did not do.).

Gorkom, the Gries directors were aware of sharp contradictions in valuation. Nevertheless, they did not consider the contrary reports, or even question the accuracy of the self-serving report.

It is difficult to reconcile *Gries* with *Trans Union*, although lip-service was paid to the standard of "informed business judgment.""[T]he end result . . . must be that each director has brought his or her own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act."[152]

The standard is obviously inconsistent with the result reached in the case. The fact that the "directors knew of the proposed acquisition months before they voted on it"[153] does not alter the situation. The failure to consider the reports suggests prejudgment of the issue, not "informed judgment."

As the dissent noted: "The Browns' directors relied on information supplied to them by an interested party . . . and made no effort to inform themselves of all relevant and material information that was reasonably available to them."[154]

The Ohio court's reliance on *Trans Union* is as misleading as its construction of other precedent.[155] *Prima facie*, the business judgment rule was inapplicable for two major reasons: (1) want of reasonable inquiry and (2) conflict of interest. Whether the transaction could have been upheld as fair, especially considering that Gries had also availed himself of the $120 repurchase of his CSC holdings, represents another query.[156]

V. TOWARDS A MORE ACTIVE BOARD

A. *Will* Graham v. Allis-Chalmers Manufacturing Co. *Survive?*

Trans Union is likely to lead to a more active board. To that extent, the celebrated *Graham*[157] ruling is likely to lose ground.

---

152. *Gries*, Nos. 4918, 19197, slip op. at 10.

153. *Id.* at 12.

154. *Id.* at 13 (Jackson, J., dissenting).

155. *E.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("When the situation involved a parent and a subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness, with its resulting shifting of the burden of proof, is applied.").

156. *See Gries*, Nos. 49184, 19197, slip op. at 11 ("The appellees never requested, and the trial court did not order the rescission of the CSC stock redemption.").

157. 188 A.2d 125 (Del. 1963).

Graham involved an action to recover losses sustained by the corporation due to its employees' violation of antitrust laws. In 1937, consent decrees were entered into by the company and others enjoining price-fixing. None of the directors before the court had been involved with the company at that time.

The Delaware Supreme Court rejected the plaintiff's contention that the directors had constructive knowledge of the violations, holding that "knowledge by three of the directors that . . . the company had consented to the entry of decrees enjoining it from doing something they had satisfied themselves it had never done, did not put the Board on notice of the possibility of future illegal price-fixing."[158] They were, therefore, not obliged to take prophylactic measures "to ensure that no employee . . . would violate the antitrust laws."[159] The law does not require "a corporate director to assume . . . that all . . . employees are incipient law violators who, but for a tight check-rein, will give free vent to their unlawful propensities."[160]

Graham has been the subject of both favorable[161] and unfavorable discussion.[162] In any event, it is arguable that *Graham* would be differently decided under *Trans Union*.

First, a suit by the Department of Justice for antitrust violations is a newsworthy, extraordinary, and (from a corporate perspective) historic event. A new director would certainly became aware of the suit if he sought information on the company's past—an emminently reasonable expectation of directors. This would, therefore, be a "reasonable inquiry" required for the proper discharge of his duties.

Second, a systematized procedure to check corporate personnel's compliance with the law is necessary today, especially in a company of Allis-Chalmers' size. The absence of such a monitoring system is, therefore, negligence per se.

Several commentators[163] had been endorsing this opinion even before *Trans Union*. The prestigious Business Roundtable stated,

---

158. *Id.* at 129.

159. *Id.*

160. *Id.* at 131.

161. *See* Veasey & Manning, *supra* note 33.

162. *See* Ward, *Fiduciary Standards Applicable to Officers and Directors and the Business Judgment Rule Under Delaware Law*, 3 DEL. J. CORP. L. 244 (1978).

163. *See* Veasey & Manning, *supra* note 33, at 930 n.53 ("The installation of legal compliance systems is . . . a new director function which will experience further development in the future"). *See* also SEC Staff Report, Corporate Account ability, in Sen. Com. on Bkg., Hsg. & Urb. Aff., 96th Cong., 2d Sess. at 695-96 (Comm. Print 1980); CORPORATE DIRECTOR'S GUIDE BOOK at 1605-06, 1610 (1972).

"Certain requirements are of major importance from both business and public points of view. Examples of these are antitrust compliance . . . . It is appropriate in these cases for the board to assure itself that there are policy directives and compliance procedures designed to prevent breaches of the law."[164] Perhaps the most important and influential of the commentators, however, is the American Law Institute.

B. *The ALI Proposal*

The prestigious ALI is likely[165] to endorse the move to more active directors. The tentative draft strongly favors a more active board; it specifically disagrees with the *Graham* ruling: "In many instances, programs or procedures (including law compliance programs) will be needed and reasonable concern about this need is consistent with sound public policy and evolving conceptions of a modern director's role."[166]

In defining the standard of care, however, the ALI should sharpen the thrust of its proposals. In certain places, it displays a penchant for needless intellectual gymnastics. For example, it differentiates between "rational basis" and "reasonable" as the standard to be employed for directors. Although the draft suggests that the "rational basis" standard permits a "significantly wider range of discretion" than the "reasonable" standard, it does not illustrate the significance of this hair-splitting.[167]

The tentative draft also makes some interesting suggestions. Most importantly, it specifies factors to evaluate the director's duty of care:[168]

(i) the importance of the business judgment to be made;

(ii) the time available for obtaining information;

---

164. Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation: Statement of the Business Roundtable*, 33 BUS. LAW. 2083, 2101 (1978).

165. The *ALI Draft, supra* note 22, has not yet been adopted by the Institute.

166. ALI, *Principles of Corporate Governance and Structure: Analysis and Recommendations* (Tent. Draft. No. 3), at 45 (1984). The omissions of this statement from the next draft (*ALI Draft, supra* note 22, at 48) does not appear to be consequential due to the tenor of the commentary.

167. *ALI Draft, supra* note 22, at 10-11.

168. The *ALI Draft* suggests that these are "factors that may have to be taken into account in judging a director's reasonable belief as to what was 'appropriate under the circumstances' . . . ." *Id.* at 66.

(iii) the costs related to obtaining information;

(iv) the director's confidence in those who explored a matter and those making presentations; and

(v) the state of the corporation's business at the time and the nature of competing demands for the board's attention."[169]

The benchmark of evaluating a director's conduct is the "ordinarily prudent person," "intended to convey the image of a generalist who has the capacity to perform his corporate assignment."[170] The "ordinarily prudent person must be in 'like position and under similar circumstances.'" Voluntary assumption of responsibility (e.g., membership in committees), the extent of involvement in the routine functioning of the corporation (e.g., full-time officers), and specialized skills, background, or expertise of a director or even his length of service on the board, may thus invite a corresponding alteration in standard.[171]

The ALI draft does not clearly state whether want of skill or experience permits a corresponding lowering of the standard of care. Illustrations 1 through 5[172] convey the impression that extraneous factors causing neglect (such as illness or athletic season) are an insufficient excuse for want of care. However, the tenor of the draft appears to be against such a lowering of care.[173]

The ALI draft also makes a very interesting, and possibly innovative, contribution to the standard of care. It seeks to make "interpersonal factors (e.g. the value of maintaining board cohesiveness and of sustaining the morale of principal senior executives)"[174] an element of the standard. Because none of the illustrations involve this factor, this implication is unclear. *Prima facie* it seems to hold tremendous mischief— potential. To the extent it is relevant, it does not need mentioning; to the extent it is mentioned, it can raise a hornet's nest in interpretation.

This is because board cohesion and high executive morale are the starting points for corporate teamwork; without them no corpo-

169. *Id.*
170. *Id.* at 19.
171. *Id.* at 24.
172. *Id.* at 17-18.
173. *Id.* at 17 ("[T]here are core functions for all directors . . . .").
174. *Id.* at 28.

ration can survive for long. Both of these are maintained whenever the board approves management proposal. "Interpersonal factors" are thus *the unarticulated basic premise* of the functioning of all corporate boards; they do not need mention. Viewed in this light, the factors adumbrated by the ALI towards the standard of care are restrictions on this premise, so that "interpersonal factors" are not carried to extremes.

From the individual director's perspective, cohesion and morale are based on personal relationships and a desire to conform. These are omnipresent influences, carrying with personality. Articulating this intrinsically pre-existent influence in the legal framework is analogous to codifying a right to breathe: by the very nature of things the right is assumed inherent, and to codify it is to invite trouble. Illustratively, a director can justify her failure to ask in-depth questions by a desire not to offend the CEO or rock the boat. The Trans Union directors would have a strong argument in defense of their decision on this ground.

C. *An Alternative Proposal?*

In an interesting article,[175] Professor Manning contends that the traditional bases for determining the director's standard of care bears no relation to the reality of board functioning today and should therefore be replaced. His perception of this "reality" is as follows:

a. The outside directors spend very little time on the corporation. A 1982 survey[176] revealed that such a director spent just about 123 hours per year, or 1.5 working days per month on their directorial responsibilities.

b. Today's corporations are large, diversified, and often international. Added to the traditional problems of business-like personnel management, competition, accounting control, and product development, this makes it impossible for a director to be fully conversant with the entire corporation.

c. The time pressure is too great. "Even issues that are fully recognized to be vitally important can often not be considered extensively by a board because its agenda is at the time crammed with other exigent items or with matters which, though less significant,

---

175. Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (Aug. 1984) [hereinafter cited as *Time for Reality*].

176. Korn Ferry International Board of Directors, Tenth Annual Study 9 (Feb. 1983).

are mandated as compulsory agenda items under applicable laws or regulations."[177]

d. All business decisions are fraught with risk. As a rule, they are made hurriedly and with sparse data. Businessmen are, thus, forced to rely on the hunches.

e. Changing social attitudes have brought people with nonbusiness backgrounds, such as minorities and women, into the board. They are inadequately informed about many matters on the board's agenda and of many aspects of normal business life.

f. Board decisions are normally consensual and informally secured beyond the official board meetings (either before or after).

g. The agenda for the board is usually set by management; directors' initiatives on this are rare.

h. A clear articulation of the "inquiry requirement" that can be universally applied is impossible.

i. The relationship of board members, *inter se*, and with top management is normally one of trust and confidence. Matters which are not within the specialization of a director are normally *sub silentio* entrusted to someone else's responsibility.

On the other hand, the traditional bases for the director's standards are drawn from analogies that were misconceived when formulated and which are misleading now. First, basing a director's obligations on "fiduciary duties" was restricted in application because the risk-taking necessary in any corporation is inconsistent with the concept of the "prudent investor."[178] Second, the courts drew on the concept of "duty of care" from the law of torts. This is fundamentally incorrect because the basic premise of the "reasonable man standard" is inapplicable. "In the general field of negligence law we are all able to talk of the 'reasonable man' and of the prudent standard of performance because we have from our daily experience a clear conception of what the actor is doing and a fairly clear conception of the way in which people normally do it."[179] But this should not be a standard for judging directors, since laymen lack a "clear conception of *what* the [director] is doing, and a community

177. Manning, *supra* note 172, at 1482.

178. *Id.* at 1490. Manning is on strong ground here. In fact, the concept of fiduciary duties of directors has so permeated discussions of the director's duty of care that courts have applied "corporate rather than trust principles in determining the liability of the directors of charitable corporations . . . ." Stern v. Lucy Webb, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

179. *Time for Reality, supra* note 175, at 1493.

understanding of a standard of normalcy about *how* he should do it."[180]

Therefore, by the traditional negligence standard, "given the realities of the way boards operate, the business judgment rule would not operate at all in respect of fully ninety percent of what directors are actually engaged in."[181]

Apparently, Professor Manning would not be happy with *Trans Union*.[182] His complaint against the "reasonable man" standard is, however, unsound. The same argument could be made in most other cases. Laymen (i.e., a jury) decide whether an anesthesiologist's infusion of a chemical into a patient, or a pilot's response to an Attitude Directional Indicator failure, was "reasonable." Let alone having a "clear conception," the jury might not even have heard of these things. Unless Professor Manning suggests an alternative system of tort liability, the case for exemption of directors is a *non sequitur*.

Worse, however, is Professor Manning's reversal of legal reality. Instead of retaining the standard of care for directors and penalizing conduct falling below such standard, courts have been lowering the standard and protecting such conduct in "fully ninety percent" of the cases.[183]

Professor Manning's six propositions for governing directors' liability, in lieu of the business judgment rule,[184] are however interesting. Without getting into cumbersome details, a director would be required to devote "such attention as, *in his good-faith business judgment*, a responsible and diligent director similarly situated should devote thereto in the circumstances . . . ."[185] Further, the director would be under an affirmative responsibility to secure a functioning management, a financial reporting system, and feedback of major business developments, and to respond to credible complaints of irregularity. Unless otherwise agreed, directors would not be required to spend more time than is "customarily expected of similarly situated directors . . . ."[186] The director would be permitted to rely on anyone[187]

---

180. *Id.* at 1494.
181. *Id.*
182. *See* Manning, *supra* note 125.
183. *See supra* text accompanying notes 42-54.
184. *See Time for Reality, supra* note 175 at 1499.
185. *Id.* (emphasis added).
186. *Id.*
187. To be sure, the formulation specifies "officers and employees of the

in whom "in his good faith business judgment, such reliance is warranted."[188] A director would have an absolute defense on these grounds.

The formulation expounds on contemporary expectations of directors, and to that extent it aids in the determination of "due care." Nevertheless, it is unclear how it eliminates the uncertainty about which Manning so fervently complains, assuming that he is not visualizing the director's "good-faith business judgment" as the preemptive, catch-all defense. The "responsible and diligent director similarly situated"[189] does not seem to be significantly different from the other formulations, "an ordinarily prudent person would exercise in like position and under similar circumstances."[190] As has been previously noted, the differences are functionally meaningless. Similarly, whether reliance on company personnel and others is *warranted* is another source of "uncertainty."[191]

One possible result flowing from Professor Manning's propositions might be that a director's plea of time-pressure would become a bone of contention. A literal reading of the propositions would find the failure of the other "similarly situated directors of the company" to spend two minutes on a question, would constitute an absolute defense. This could foster a conspiracy of silence.

It seems clear, however, that the Trans Union directors would not be liable under Manning's propositions. After all,"similarly situated directors of the company" relied upon Jerome Van Gorkom entirely.

VI. *TRANS UNION* AND HOSTILE OFFERS

Trans Union involved a friendly transfer of corporate control. Whether its "reasonable inquiry" requirement will be adopted for hostile takeovers—and if so, to what extent—are open inquiries. At this stage, it seems worthwhile to analyze the basic distinction between hostile takeovers and routine business affairs, the "primary purpose" test,[192] and the possible effect of the "reasonable inquiry" requirement on the market for corporate control.

---

company, outside consultants, committees of the board and individual members of the board . . . ." *Id.*

188. *Id.*

189. *Id.*

190. *See supra* text accompanying notes 22-41.

191. *See supra* notes 59, 108-112 and accompanying texts.

192. *See infra* part VI(B).

A. *Hostile Offers and "Other Business Matters"*

Major distinctions between hostile offers and routine business issues can be grouped into two categories: macro and micro. The former involves the corporation's role in a free society, while the latter focuses on the corporation itself.

A corporation's regular business functions include supplying goods and services to society. In the context of a hostile bid to acquire control, the corporation functions as a medium for allocation of resources. It is a canon in our society of free enterprise that "when assets change hands they usually move into stronger ones."[193] Before hostile takeovers became the terror of the corporate world, it was frequently observed that "[t]he former involves corporate functioning in competitive business affairs in which judicial interference may be undesirable. The latter involves only the corporation-shareholder relationship, in which the courts may more justifiably intervene to insist on equitable behavior."[194]

In the micro sense, hostile tender offers present a conflict of interest in a peculiar way. In routine decisions, the interests of the participants in the corporate enterprise, i.e., shareholders, management, and employees, are often similar. In the face of a tender offer, however, the shareholders' interest is opposed to that of management. Shareholder profit is frequently pitted against the jobs of the management and often those of directors. Consequently, some commentators have suggested that the business judgment rule should be inapplicable in the context of tender offers because of such an inevitable conflict of interest.[195] Others have contended that a tender offer presents a business decision like any other and, hence, is fully protected within the confines of the business judgment rule.[196]

Tender offers present an inherent conflict of interest between target management and the shareholders, and this has been often recognized by the judiciary.[197] Nevertheless, a board's decision in

---

193. *The Raiders*, Bus. Wk., Mar. 4, 1985, at 80, 82.

194. Note, *Protection for Shareholder Interests in Recapitalizations of Publicly Held Companies*, 58 COLUM. L. REV. 1030, 1066 (1958).

195. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *supra* note 1.

196. *See* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 117, 123-24 (1979) [hereinafter cited as Lipton]; Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980).

197. *See* Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981) ("in the context of a tender offer, the directors have an inherent conflict of interest");

the context of a tender offer will call for a review on its merits only if the sole objective of the director's decisions was to maintain control. This "primary purpose" test[198] is not significantly different from the business judgment rule.[199]

B. *The "Primary Purpose" Test and Outside Directors*

The "primary purpose" test is perhaps best illustrated by *Panter v. Marshall Field & Co.*,[200] a Seventh Circuit decision on a frustrated suitor's challenge to takeover defenses of the target company, Marshall Field. Seven of Field's ten directors were outsiders. In response to an inquiry from Carter Hawley Hale (CHH), Field's board unambiguously resolved *not to consider* a merger. On December 10, CHH threatened to launch a hostile offer if the board did not accept its offer[201] by the 12th.

In response, Field's board held a meeting on the 12th. The company's investment bankers were not asked to evaluate the offer, or to determine the intrinsic value of the Field shares.[202] The board accepted Field President Arena's optimistic projections of future earnings growth (193% in five years) as opposed to the lower projections of the professional, investment bankers (63%). This occurred despite the fact that Arena had been with Field for less than two months.[203] The board also sought to acquire Dillards, a company about which it knew little,[204] solely in order to raise antitrust obstacles to CHH's offer.

When this failed, the board committed $24 million to acquire

Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) ("whenever a tender offer is extended and the management of the threatened company resists, the officers and directors may be accused of trying to preserve their jobs at the expense of the corporation"). *See generally* Gilson, *supra* note 1.

198. Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

199. "Although not precisely so articulated, the primary purpose test is perhaps somewhere between the 'business judgment' and 'fairness' tests of state law." A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES & PLANNING 86-87 (1978). *See also* Lipton, *supra* note 196, at 102; Rosenzweig, *The Legality of "Lock-Ups" and Other Responses of Directors to Hostile Takeover Bids or Stock Aggregations*, 10 SEC. LEG. L.J. 291, 294 & n.8 (1984)

200. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

201. The offer was for $36 worth of their own securities for each Field share. *Panter*, 454 U.S. at 1095.

202. *Panter*, 646 F.2d at 307 n.15.

203. *Id.* at 307 n.16.

204. It was evaluated by "intuitive judgment" of a Field officer. *Id.*

five Liberty Stores. This occurred without historical operating data and with patently suspect earnings potential.[205] At the same time, the Field board also committed $17 million for expansion in Galleria (Houston) where CHH had an outlet.

The Field board thus made expansion commitments totalling $41 million during a busy "Christmas season in which their 'top priority' was to help a new chief executive officer become familiar with Field's operation."[206]

All actions were pursuant to Field's longstanding policy of opposing takeovers. In response to several overtures in the late 1960s, Field had sought advice on avoiding such attempts. They were advised to invest the company's reserves and acquire other stores by using the company's borrowing power "if such acquisitions were in accord with the sound business judgment of the board, and in the best interest of the company and its shareholders."[207] Field had followed this policy faithfully ever since, thereby acquiring (or threatening to acquire) businesses whenever confronted with an unwanted proposal.

The Seventh Circuit was apparently unconcerned by the fact that the Field board had not evaluated the CHH offer. The court stated: "There was no discussion of the adequacy of the offer in light of the board's *determination* that the proposed combination would clearly be illegal."[208]

And what was this determination? In response to CHH's December 10 offer, Field President Arena had a conversation with the company's counsel, who believed the merger would be illegal. CHH's counsel, on the other hand, saw no insurmountable problems. Without further written opinion or discussion, "the emergency anti-takeover cabal"[209] decided to file suit and seek intervention from federal and state regulatory agencies.[210] If the proposed merger was not already illegal, the board was determined to make it so.

Nevertheless, the court found that the decision was protected by the business judgment rule. A majority of the directors were outsiders, and the court commented that the "primary purpose" was not to retain control. Judge Cudahy's response to this cannot be improved upon. He observed: "[T]he very idea that, if we cannot

205. *Id.* at 308. Field's own vice-president reported "marginal" potential.
206. *Id.*
207. *Id.* at 278.
208. *Id.* at 280.
209. *Id.* at 309 (Cudahy, J., dissenting).
210. FTC, SEC, and the Illinois Security Commission.

trace with precision a mighty flow of dollars into the pockets of each of the outside directors, these directors are necessarily disinterested arbiters of the stockholders' destiny, is appallingly naive."[211]

"Outside" directors had thus become corporate guarantors for the protection of the business judgment rule. This has continued despite the recognition that the board is usually dominated by management, even if a majority of the directors are outsiders.[212] It has also been accepted willy nilly in cases involving the business judgment indirectly. The Seventh Circuit's ruling in *Mite Corp. v. Dixon*[213] provides an example.

Mite involved the validity of a provision of the Illinois Business Take-Over Act.[214] This provision required the Illinois Secretary of State to hold a hearing on the equity of a tender offer if a majority of outside directors so requested. The court's objection was that "in a significant number of cases management will be able to use the provision . . . through its ability to influence outside directors."[215] Even assuming a lack of legislative intent to favor management in a tender offer, this result was ineluctable.

The same result followed in the recent, well-known *Unocal Corp. v. Mesa Petroleum Co.* takeover battle,[216] in which the Delaware Supreme Court reaffirmed[217] the "primary purpose" test. The court found that the board had a "large reservoir of authority"[218] in responding to a hostile offer. Directors' decisions are protected by the business judgment rule so long as they are not primarily motivated

---

211. *Panter*, 646 F.2d at 300 (Cudahy, J., dissenting).

212. Gelfond & Sebastian, *Reevaluating the Duties of Target Management in the Hostile Tender Offer*, 60 B.U.L. REV. 403 (1980).

213. 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom.* Edgar v. Mite Corp., 457 U.S. 624 (1982).

214. ILL. REV. STAT. ch. 12-1/2, § 137.51 (1979).

215. *Panter*, 633 F.2d at 494-95.

216. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (1983). Mesa Petroleum (T. Boone Pickens) made a two-tier front-end loaded tender offer for Unocal's shares. Unocal responded with a share-repurchase offer (in exchange for Unocal debt securities), excluding Mesa from participating under the offer. The battle was fought—like many others—in three sets of courts, apart from the media. A preliminary injunction on antitrust grounds was denied to Unocal by the United States District Court for Western Louisiana. A preliminary injunction under the Williams Act was denied to Mesa by the United States District Court for Central California. A preliminary injunction was granted to Mesa by the Delaware Chancery Court under Delaware law, but vacated by the Delaware Supreme Court.

217. *Id.*

218. *Id.* at 953.

by their own entrenchment.[219] However, the court stressed that the issue would turn on "whether the defensive measure is reasonable compared to the threat posed by the bidder."[220] The board did not have "unbridled discretion to defeat any perceived threat by any Draconian means available."[221]

It is submitted that read together, *Trans Union* and *Unocal* might imply this: since every business decision of the board must be "informed" by *Trans Union* standards, a reasonable inquiry would be required on each facet of the takeover battle (the "threat" and possible defenses), and the response must be selected after due deliberation. If the board meets these requirements, Delaware courts would deem their defense to be "appropriate," unless it is patently outrageous.

To contend that "reasonable inquiry" is not required in case of hostile offers would be inconsistent with *both* decisions. First, *Trans Union* does not authorize such an exception. Second, *Unocal* would imply much more than what the court could have presumably meant. Delaware courts would then have to review the "threat" posed by a hostile offer (whatever that means) and the "defenses" taken by the target board to determine whether the board's responses were "appropriate." Consequently, a board's actions would be protected by the business judgment rule if they are found appropriate. This would make nonsense of the business judgment rule.

It is premature to say whether *Unocal* signifies a trend. The ruling was issued under extreme time pressure[222] and, it appears to be have been influenced by the fact that a two-tier, coercive offer was made by a "corporate raider with a national reputation as a greenmailer."[223] The *Unocal* court was impressed, as were other courts,[224] with the "outside directors," though these directors held shares in the corporation.

If *Unocal* is any indication, *Trans Union's* effect on the tension-laden field of hostile offers could be electrifying. Should "reasonable inquiry" be required before the "primary purpose" test is applied,

---

219. *Id.* at 954.

220. *Id.* at 955.

221. *Id.*

222. The chancery court granted the preliminary injunction sought by Mesa on May 13, 1985. The Delaware Supreme Court vacated that injunction on May 17, 1985, and issued its opinion on June 10, 1985. *Id.* at 952-53.

223. *Id.* at 956.

224. *See supra* text accompanying notes 200-211.

Panter would be substantially diluted. Almost every action taken by Field's board in response to the hostile offer would be seriously suspect for want of reasonable inquiry. Since not every hostile offer is made by a "corporate raider with a national reputation as a greenmailer," *Unocal* might not prove to be much help.

Further, directors' liability insurance premiums would likely be raised substantially if coverage remained available at all. Outside directors would thereby become more expensive, and more aggressive. Thus, should *Trans Union* be taken to its logical extent in hostile takeovers, outside directors will cease to be darlings of corporate management.

VII. CONCLUSION

While directors have always been expected to adhere to the "reasonable man's standard of care,"[225] very few actually have been held liable for not meeting that standard.[226] The business judgment rule has been a teflon-coating for directors.[227]

Trans Union illustrates, for the first time, the frontiers of the rule. It goes beyond the precedents and holds directors to a requirement of reasonable inquiry. While it clarifies the *causal nexus* required for such cases, it is likely to increase lawyer participation in corporate transactions. The lengthy factual discussion, however, could cause considerable confusion about its precise meaning.

The trend in legal thinking—beyond the courts for the most part—has been towards a more active board. Attempts at formulating the duty of care have yet to be fully justified. Presently they are significant only as guideposts in determining the "reasonableness" of the impugned behavior. This is inevitable, as diversity in the size and functions of corporations and corporate directors do not permit such straitjacketing. That *Trans Union* was decided *dehors* specific statutory authority underscores this.

Trans Union is thus in tune with contemporary thinking; that it was decided by the Delaware Supreme Court makes it doubly influential. If it is adopted as an element of the "primary purpose"

---

225. As early as 1924, Judge Learned Hand spoke of directors' "individual duty to keep themselves informed in some detail." *Barnes*, 298 F. at 615-16.

226. *See supra* text accompanying notes 42-55.

227. For an extensive discussion, see generally NADER, *supra* note 139; Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976).

test used in reviewing director conduct in hostile offers—as *Unocal* indicates that it could be—it would drastically affect the market for corporate control. In sum, *Trans Union* is a long-overdue judicial affirmation of the need for better informed directors and, consequently, more responsible corporate behavior.