DIRECTOR OVERSIGHT LIABILITY: TWENTY-FIRST CENTURY STANDARDS AND LEGISLATIVE CONTROLS ON LIABILITY

BY JAMES L. GRIFFITH, JR.*

TABLE OF CONTENTS

*Mr. Griffith graduated *cum laude* from Widener University School of Law, where he served as an Articles Editor to *The Delaware Journal of Corporate Law*. Currently, he is a member of the Pennsylvania and New Jersey bars and is an associate in the Philadelphia law firm of Wolf, Block, Schorr and Solis-Cohen, where he practices in the areas of business and commercial litigation.

I. INTRODUCTION

As the year 2000 approaches, new challenges face corporate America. Global competition,[1] government regulation,[2] and information technology[3] are but a few of the hurdles corporations must successfully manage to stay ahead of the pack. These new inputs in the management equation are certain to be topics of concern in corporate boardrooms across America; industry leaders will be forced to venture into uncertain waters. When they do, they will undoubtedly attract the attention of the public and, more importantly, the stockholders.

Courts, too, will be forced to adapt to the looming changes. Because Delaware is home to a majority of the Fortune 500 companies,[4] the brunt of change will be borne by its judiciary. To date, Delaware courts, in particular the court of chancery, have proven that they are capable of handling new trends in corporate law.[5]

This article addresses a familiar corporate law concept in Delaware and nationwide: the business judgment rule.[6] More specifically, this article focuses on when the rule does not apply.[7] The business judgment

---

[1]*See infra* notes 149-53 and accompanying text.

[2]*See infra* notes 140-48 and accompanying text.

[3]*See infra* notes 154-72 and accompanying text.

[4]Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 889 (1990).

[5]The "merger mania" of the 1980s and the litigation it produced is a clear testament to the adaptability of the Delaware judiciary. The merger frenzy injected not just terms of art, such as leveraged buyout (LBO), junk bond, greenmailer, and white knight, but whole new constructs such as the poison pill. In a two year period, the Delaware Supreme Court fashioned the backbone of modern merger law in Delaware. *See generally* Revlon v. MacAndrews & Forbes, 506 A.2d 173 (Del. 1986) (establishing director duties in the context of sale of control); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (establishing standards governing creation of the poison pill); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (establishing enhanced business judgment rule to govern directors' use of defensive measures); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (establishing directors' standard of care in evaluating proposed merger). The standards set forth in these cases were later refined in Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1993) (applying *Revlon*); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (applying *Unocal*); Mills Acquisition v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989) (applying *Revlon*); and Ivanhoe Partners, Inc. v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) (applying *Unocal*).

[6]For a discussion of the business judgment rule, see *infra* notes 25-34 and accompanying text.

[7]For a discussion of when the business judgment rule does not apply to a board decision involving the duty of care, see *infra* notes 35-63 and accompanying text. For a discussion of the inapplicability of the business judgment rule when there is no board decision, see *infra* notes 64-66 and accompanying text.

rule resulted from judicial restraint.[8] Judges recognized that they were in no position to second-guess directors' decisions and, therefore, deferred to directors' judgment.[9] In analyzing a challenged transaction, courts presume directors acted with the best intentions for the company and informed themselves prior to making a decision.[10] The plaintiff must rebut this presumption.[11] The deference extended to the board is not without limit, however. For instance, judicial restraint cannot be exercised when the board has not made a decision.[12] Absent a decision, the business judgment rule does not apply.[13]

---

[8]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993). "The rule exists to preclude a court from imposing itself unreasonably on the business and affairs of a corporation." *Id.* "The traditional setting of the business judgment rule is *defensive*: directors will not be held personally liable in damages for honest mistakes of judgment." 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.6, at 4-42 (2d ed., 1993) (emphasis added). Balotti and Finkelstein provide additional reasons for the rule's creation, namely, the idea that the directors manage the corporation, the need to encourage risk-taking by directors, and the need to minimize exposure to liability in order to encourage competent directors to serve on the boards of Delaware corporations. *Id.* § 4.6, at 4-38.

[9]1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.6 at 4-40. "Where the courts find that the business judgment rule applies, the business decisions of disinterested directors 'will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.'" *Id.* (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

[10]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[11]*Cede*, 634 A.2d at 361.

[12]*Aronson*, 473 A.2d at 813. The business judgment rule also does not apply when directors face a conflict of interest or engage in self-dealing. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (involving directors who served on boards of both the parent and the subsidiary corporation). In such situations, courts apply the "entire fairness" test. *Id.* When the "entire fairness" test is applied, courts no longer presume that the directors acted in good faith; rather, the defendants must "demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." *Id.*

[13]*Aronson*, 473 A.2d at 813. Without the business judgment rule to guide them, courts approached director oversight liability with caution and uncertainty. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963) (discussed at length herein as the most famous, and perhaps the first, Delaware decision to address director liability in the context of oversight). At a lecture delivered to Delaware's bench and bar, Justice Henry Horsey (Ret.) of the Delaware Supreme Court opined extra-judicially that the language in the *Graham* decision indicated that the supreme court had not previously addressed the duty of care standard in Delaware. Henry R. Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 986 (1994). Specifically, he quoted the court's annunciation of the prudent man standard: "[I]t appears that directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances." *Id.* (citing *Graham*, 188 A.2d at 130). Justice Horsey added that the court, having no standard of its own, was forced to rely on a U.S. Supreme Court decision, Briggs v. Spaulding, 141 U.S. 132 (1891). *Id.*

The inapplicability of the business judgment rule is perhaps one of the most critical features of a director oversight claim. The essence of a director oversight claim is that the directors failed to detect or deter some wrongdoing on the part of management or other members of the board.[14] These claims are ordinarily portrayed as a violation of a director's duty of care,[15] but some factual scenarios implicate the duty of loyalty.[16] In the latter cases, the plaintiff usually argues that the directors have completely abdicated their directorial responsibilities.[17]

The defenses to director oversight claims are equally typical. Reliance on management or other directors[18] and valid delegation of duty[19] are often claimed to justify the board's omission.[20] However, as previously stated, the absence of a business decision removes the business judgment rule from the directors' list of available defenses.[21]

This article revives an old debate and raises, perhaps, a new one. The old debate is over which standard applies to the board's conduct when it does not make a business decision. The topic is timely in light

---

[14]In other words, the board failed to make a decision because it was unaware that a problem existed. *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 127 (Del. 1963) (board failed to discover price-fixing); Rabkin v. Phillip A. Hunt Chem. Corp., No. 7547, slip op. at 1 (Del. Ch. Dec. 17, 1987), *reprinted in* 13 DEL. J. CORP. L. 1210, 1213 (1988) (board failed to discover stock purchase agreement of controlling shareholder prior to merger); Lutz v. Boas, 171 A.2d 381, 388 (Del. Ch. 1961) (outside directors failed to discover inside directors earned illegal fees).

[15]*See infra* text accompanying notes 92-104.

[16]*Id.*

[17]*See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814, 819 (N.J. 1981) (director made no effort to ensure compliance with company policy and procedures); *Lutz*, 171 A.2d at 396 (directors gave "scant attention" to their duties).

[18]For a discussion of the concept of reliance and its use in the director oversight context, see *infra* notes 89-91 and accompanying text.

[19]For a discussion of the concept of delegation and its use in the director oversight context, see *infra* notes 84-88 and accompanying text.

[20]Although it may seem odd to speak of liability through omission, the law has traditionally imposed liability for failure to act where there is a duty to do so. *See, e.g.*, RESTATEMENT (SECOND) OF Torts § 284 (1965) (defining negligent conduct as "a failure to do an act . . . which the actor is under a duty to do"). Corporate law is no stranger to duty. In this arena, directors are obligated to act with care, and they are required to be loyal to the corporation and its shareholders. *See infra* notes 25-30 and accompanying text (discussing directors' duties). Deviants from these duties pay the price for their misdeeds. *See Van Gorkom*, 488 A.2d at 893 (holding that board of directors breached their fiduciary duties by failing to fully inform themselves in connection with a merger transaction and by failing to disclose all material information to shareholders). However, corporate law employs an analysis different from the situations described above. Under the business judgment rule, a plaintiff need not present evidence of causation or damages. *Cede*, 634 A.2d at 367.

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

of the challenges on the horizon which directors will face,[22] and the new strategies currently employed to attack their actions.[23] This article concludes that there are two common fact patterns in the field of director oversight liability: oversight and complete abdication. A standard which focuses on the elements of delegation and reliance will best serve the analysis of an oversight claim. Modern developments, however, suggest that the underlying assumptions of delegation and reliance may be changing. This article highlights some of the potential changes and discusses their impact on a director's liability in the oversight context. In the abdication context, courts should employ a duty of loyalty analysis. This analysis is easily applied and is most consistent with the policy of the Delaware General Corporation Law.

The new debate is whether legislatively created exemptions from personal liability will protect directors when the business judgment rule does not apply.[24] The aforementioned analysis yields a result which should encourage directors, but nevertheless bespeaks caution.

---

[22]*See infra* notes 137-72 and accompanying text.

[23]*See, e.g.*, James P. Murphy, *Duties, Standards of Liability, and Recent Litigation Developments Relating to Officers and Directors*, *in* DEFENDING BANK AND THRIFT DIRECTORS AND COUNSEL IN THE 90S, at 381 (PLI Litig. & Admin. Practice Course Handbook Series No. H-482, 1993) (summarizing the standards of care governing directors and officers of banks and thrifts). Although Mr. Murphy discussed the liability of bank directors in lawsuits filed by the government, many of his comments are relevant to the civil lawsuit filed by the private plaintiff:

> When the government first began bringing lawsuits against officers and directors, many attorneys thought the business judgment rule would provide a substantial basis for protecting their clients from liability. Somewhat surprisingly, that has turned out not to be true. The reason is that the government, except in a case in which fraud is alleged, rarely, if ever, challenges the business judgment rule head on. Rather, the main focus of the government's attack is almost always on whether the officers and directors made their decisions on an informed basis. In other words, the allegation rarely is that a failed financial institution never should have pursued a particular loan program, but is that the institution, in considering whether to adopt the program and in carrying it out, failed to hire competent people, failed to provide information necessary in order to make a wise decision, etc., etc. In other words, it is the means chosen by an institution to do something, rather than the act itself that typically forms the basis of the claim.

Id. at 388-89.

[24]Section 102(b)(7) of the Delaware General Corporation Law is the relevant statute. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

II. PART ONE: DIRECTOR OVERSIGHT LIABILITY

A. *Business Judgment Rule*

1. The Rule

The business judgment rule dominates judicial thinking in corporate law.[25] The rule's pervasiveness is the result of its origin in the fundamental principle of Delaware corporate law which commits the management of the corporate enterprise to the direction or supervision of the board of directors.[26] As managers of the corporate enterprise, directors owe fiduciary duties of loyalty and care to the corporation and its stockholders.[27] The elements of the business judgment rule reflect

---

[25]When legal scholars devote an entire text to a rule, it seems accurate to assert that the rule is dominant. *See* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE (4th ed. 1993). Other commentators on Delaware corporate law devote a substantial portion of their treatises to a discussion of the business judgment rule and its applications. *See* 1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.6; ERNEST L. FOLK ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2, at 141:9 (1992); *see also* 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (perm. ed. 1994) (discussing the business judgment rule's application in Delaware and other states). The business judgment rule is so basic to corporate law that The American Bar Foundation developed a model corporations act which includes its own version of the rule. *See* American Bar Foundation, MODEL BUSINESS CORP. ACT § 8.30 (1991).

[26]FOLK ET AL., *supra* note 25, § 141:21. The fundamental principle is codified at DEL. CODE ANN. tit. 8, § 141(a) (1991). Section 141(a) states that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." *Id.* Although the principle is well established in Delaware law, business leaders have questioned the board's usefulness in modern times. *See* A.L. JAGOE, THE WINNING CORPORATION 35 (1987). Although Jagoe supports the use of a board of directors in public corporations, he admits that, to a degree, the board as a control mechanism is little more than a "legal fiction." *Id.* at 36. According to Jagoe, the "growing tyranny of management" currently exercises control over the corporation. *Id.*

[27]Polk v. Good, 507 A.2d 531, 536 (Del. 1986); *Van Gorkom*, 488 A.2d at 872-73. The idea that directors act as fiduciaries vis-à-vis the corporation and its shareholders originated in the law of trusts. FLETCHER, *supra* note 25, § 838. Although directors are fiduciaries, strictly speaking, directors are not considered trustees. Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

As fiduciaries, directors must first be loyal to the corporation and the shareholders. *Polk*, 507 A.2d at 536; *Van Gorkom*, 488 A.2d at 872-73; FOLK ET AL., *supra* note 25, § 141:13. Although there is no "hard and fast rule" to determine when a director is disloyal, it is clear that directors may not engage in self-interested transactions. *Guth*, 5 A.2d at 510. Directors may not stand on both sides of a transaction without attracting the "careful scrutiny [of] the courts." *Weinberger*, 457 A.2d at 710. Conflicts of interest often occur in situations involving corporate control because of the potential for management to entrench themselves in

these duties as well as the directors' right to guide their company as they see fit.[28] The oft-quoted case of *Aronson v. Lewis*[29] states the modern version of the Delaware rule: "[There] is a presumption that in making

---

office. *Unocal*, 493 A.2d at 954-55. Directors who profit at the expense of the corporation must disgorge those profits. *Guth*, 5 A.2d at 510.

Loyalty also requires that the directors conduct their own independent analysis of a transaction. *Aronson*, 473 A.2d at 816. In other words, although directors must act together as a board, they may not blindly follow a dominating CEO or "succumb[ ] to [other] influences." *Id.* They must exercise their own, independent judgment as to the corporate merits of a transaction. *Id.* Finally, loyalty imposes a duty of candor on the board when they seek shareholder approval of a specific corporate action. Kahn v. Roberts, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,201, at 99,410 (Del. Ch. Feb. 28, 1994) (citing Zim v. VLI Corp., 621 A.2d 773 (Del. 1993)). The duty of candor requires that directors disclose all material facts so that the shareholders can be adequately informed before making their decision. *Id.* Directors who voluntarily disclose information which they are not otherwise required to disclose are under the same obligation to deal in a candid manner with the shareholders. *Id.*

Directors also have a duty to exercise proper business judgment, i.e., to act with due care. Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988). Proper business judgment includes both substantive and procedural due care. *Id.* Substantive due care incorporates allegations of waste. *Id.* (citing Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962)). The substantive due care standard is "whether 'what the corporation received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid.'" *Id.* (quoting *Saxe*, 184 A.2d at 610). Procedural due care looks to whether the directors made an informed decision. *Id.* (citing *Van Gorkom*, 488 A.2d at 872-73). The due care standard is gross negligence. *Aronson*, 473 A.2d at 812 & n.6. The duty of care standards are discussed further herein. *See infra* text accompanying notes 35-63.

[28]*Cede*, 634 A.2d at 360; *Aronson*, 473 A.2d at 812. *Aronson* established the criteria which, if met, excused a shareholder's failure to make demand upon the board prior to filing a derivative action. *Id.* at 814. Under Delaware law, the business judgment rule plays a critical role in a derivative action. *Id.* at 812. Demand is excused, then, when the complaint creates "a reasonable doubt . . . that (1) the directors are disinterested and independent [or] (2) the challenged transaction [is] otherwise the product of a valid exercise of business judgment." *Id.* at 814. In deciding whether directors are disinterested or independent, a court must decide whether the facts alleged create "a reasonable doubt . . . that the protections of the business judgment rule are available to the board." *Id.* Courts viewed the *Aronson* test as a major new hurdle for plaintiffs who wished to file derivative lawsuits. In Kaufman v. Belmont, 479 A.2d 282 (Del. Ch. 1984), the court of chancery stated that "[o]bviously, this new standard imposes a higher burden on a plaintiff who seeks to be excused from making a demand by showing its futility." *Id.* at 286. The commentators were equally pessimistic. *See* Dennis J. Block & H. Adam Prussin, *Termination of Derivative Suits Against Directors on Business Judgment Grounds: From* Zapata *to* Aronson, 39 BUS. LAW. 1504, 1505-06 (1984) (stating that under *Aronson*, "demand will almost always be required"). The Delaware Supreme Court applied the *Aronson* test on five occasions before it decided a case in favor of a derivative plaintiff who had not made demand upon the board. *See* Levine v. Smith, 591 A.2d 194, 205 (Del. 1991) (holding demand was not excused); *see also* Speigel v. Buntrock, 571 A.2d 767, 774 (Del. 1990) (same); *Grobow*, 539 A.2d at 186 (same); Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (same); *Aronson*, 473 A.2d at 814 (same); *cf.* Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992) (holding demand was excused).

[29]473 A.2d 805 (Del. 1984).

a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[30]

The presumption must be overcome before courts will impose liability.[31] Plaintiffs may overcome the presumption by showing that the directors: (1) are interested in the transaction or failed to exercise their own independent business judgment, (2) abused their discretion, (3) failed to act in good faith, (4) failed to exercise due care, or (5) did not make a business decision.[32] "[T]he business judgment rule is not a standard of conduct, but only a tool of judicial review."[33] Thus, to overcome the presumptions of the business judgment rule,

> a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty--good faith, loyalty, or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the "entire fairness" of the transaction to the shareholder plaintiff.[34]

This article is primarily concerned with the fiduciary duty of due care. In order to resolve the question of what standard should control directors' actions in the absence of a decision, it is useful to know the standards which control when a decision has been made. The article discusses this topic below. Also discussed in more detail is the requirement that the directors make a business decision before the business judgment rule will apply.

---

[30] *Id.* at 812.

[31] *Cede*, 634 A.2d at 361; 1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.6, at 4-47. The burden to overcome the presumption is a heavy one. *Id.*

[32] BLOCK ET AL., *supra* note 25, at 20. *See also* Charles Hansen, *The Duty of Care, the Business Judgment Rule, and The American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355, 1369 (1993) (arguing that the application of the business judgment rule requires "the presence of process due care, subjective good faith, disinterest, and independence" and "the absence of waste, egregious conduct, illegality, fraud, and ultra vires conduct").

[33] 1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.7, at 4-169.

[34] *Cede*, 634 A.2d at 361 (citations omitted).

2. Due Care Standards in the Business Decision Context

Plaintiffs who seek to overcome the presumption of the business judgment rule on due care grounds bear the burden of proving that the directors did not exercise proper business judgment.[35] Proper business judgment includes both substantive and procedural due care.[36] Under Delaware law, directors exercise substantive due care when their decision "can be attributed to any rational business purpose."[37] The "rational business purpose test" is not applied uniformly, however.[38] When the decision involves the control of the corporation or the termination of a derivative suit, courts are more willing to examine the merits of a decision than when the decision involves the "business" of the corporation.[39] Substantive due care also incorporates allegations of waste.[40] The standard for waste is "whether 'what the corporation received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid.'"[41] Claims of waste arise in diverse factual settings. For example, waste may involve the sale of assets,[42] the terms of a merger agreement,[43]

---

[35]*Grobow*, 539 A.2d at 189.

[36]*Id.*

[37]*Sinclair*, 280 A.2d at 720. The "rational business purpose" test is linked to the good faith requirement of the business judgment rule. E. Norman Veasey & Julie M.S. Seitz, *The Business Judgment Rule in the Revised Model Act, the* Trans Union *Case, and the ALI Project--A Strange Porridge*, 63 TEX. L. REV. 1483, 1485-86 (1985) (stating that frivolous, capricious, or irrational decisions would not be in good faith). What is rational is usually defined by a standard of reasonableness. *Id.*; S. Samuel Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 656 (1979). An irrational or unreasonable decision would also constitute an "abuse of discretion." *Id.* at 657.

[38]Veasey & Seitz, *supra* note 37, at 1486. Veasey and Seitz suggest that

> decisions involving new product lines, plant locations, marketing strategies, borrowing practices, or the like--no matter how ill-advised, stupid, or questionable--are unlikely to be set aside by courts or to result in personal liability. . . . Even in such a case, however, no certain prediction of the outcome can be made because it is conceivable that some redeeming rational circumstance could be found.

Id. (footnote omitted).

[39]*Id.*

[40]*Grobow*, 539 A.2d at 189 (citing *Saxe*, 184 A.2d at 610).

[41]*Id.* (quoting *Saxe*, 184 A.2d at 610).

[42]Andreae v. Andreae, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,571, at 92,646, 92,650 (Del. Ch. Mar. 3, 1992), *reprinted in* 18 DEL. J. CORP. L. 197, 210 (1993); *In re* NVF Co. Litig., No. 9050, 1990 Del. Ch. LEXIS 167, at *1-2 (Del. Ch. Nov. 21, 1989).

[43]Avacus Partners, L.P. v. Brian, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,232, at 91,209, 91,212 (Del. Ch. Oct. 24, 1990), *reprinted in* 16 DEL. J. CORP. L. 1425, 1433 (1991).

the reduction of the option price on pre-existing options,[44] the amounts of severance payments,[45] the repurchase of company stock,[46] the terms of compensation and employment contracts,[47] the payment of dividends,[48] and the cancellation of stock options.[49]

Procedural due care analysis is distinct from substantive due care analysis.[50] Directors comply with the procedural due care requirement when they make informed decisions and "act with requisite care in the discharge of their duties."[51] *Smith v. Van Gorkom*[52] provided the meaning of an "informed" decision:

> The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves "prior to making a business decision, of all material information reasonably available to them."
>
> Under the business judgment rule there is no protection for directors who have made "an unintelligent or unadvised judgment." A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the corporation, he must execute that duty with the recognition that he acts on behalf of others. . . . 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 . . . .[53]

---

[44]Stein v. Orloff, No. 7276, 1985 WL 21136, at *1 (Del. Ch. May 30, 1985), *reprinted in* 11 DEL. J. CORP. L. 312, 314 (1986).

[45]Lewis v. Hett, No. 6752, 1984 WL 8258, at *1 (Del. Ch. Sept. 4, 1984), *reprinted in* 10 DEL. J. CORP. L. 240, 242 (1985).

[46]*Grobow*, 539 A.2d at 185.

[47]*Stein*, No. 7276, 1985 WL 21136, at *5, *reprinted in* 11 DEL. J. CORP. L. at 320.

[48]*In re* Rexene Corp. Shareholders Litig., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,010, at 90,055-90,056 (Del. Ch. May 8, 1991), *reprinted in* 17 DEL. J. CORP. L. 342, 346 (1992).

[49]*Kaufman*, 479 A.2d at 284.

[50]Veasey & Seitz, *supra* note 37, at 1486.

[51]*Aronson*, 473 A.2d at 812; *see also Grobow*, 539 A.2d at 189 (stating duty of care requires that directors be informed); *Van Gorkom*, 488 A.2d at 872-73 (same).

[52]488 A.2d 858 (Del. 1985).

[53]*Id.* at 872 (citations and footnote omitted).

In assessing whether directors are properly informed, Delaware courts employ a gross negligence standard.[54]

Procedural due care also requires that directors "act with requisite care in the discharge of their duties."[55] The Delaware statute governing the responsibilities of boards, however, does not provide a laundry list of a board's duties.[56] Nevertheless, it is clear that directors can be liable for breaching the duty of care through acts separate from their failure to be informed.[57] The gross negligence standard of care also applies in this context.[58] Historically, gross negligence has been identified with terms such as fraud, overreaching, and abuse of discretion.[59] Whatever gross negligence may encompass, it has not always played a critical role in determining the outcome of a given case; rather, the determination of a duty of care violation usually depends on the particular facts and circumstances of each case.[60] It is likely that the determination will also be based on whether the directors were informed and exercised

---

[54]*Id.* at 873. In *Van Gorkom*, the directors of the Trans Union corporation were found to be grossly negligent when they decided to sell the company after only two hours of consideration. *Id.* at 874. Although the directors "were well informed about the company and its operations as a going concern," *id.* at 868, the court found that the directors never properly informed themselves about the role which Trans Union CEO and chairman, Jerome Van Gorkom, played in establishing the purchase price or the intrinsic value of the company. *Id.* at 874.

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

[56]DEL. CODE ANN. tit. 8, § 141(a) (1991). It has been noted that

> it is futile to hope that the functions and the responsibilities of such a board of directors could be delimited in any precise pattern by a form of words, but like other human institutions they must struggle to apply a generalized concept to the diversities of the particular personalities and circumstances that they face.

E. Norman Veasey & William E. Manning, *Codified Standard--Safe Harbor or Unchartered Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 923 (1980) (quoting remarks of George D. Gibson, at Symposium, *Officers and Directors Responsibilities and Liabilities*, Oct. 21-22, 1971, *reprinted in* 27 BUS. LAW. 41, 46 (1972)). However, the court has defined the directors' duties in certain fact situations. *See, e.g.*, Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989) (asserting that directors must take an active role in the sale of a company); *Van Gorkom*, 488 A.2d at 873 (holding that directors may not abdicate the duty to be informed in a merger context).

[57]*See supra* text accompanying note 53.

[58]*Aronson*, 473 A.2d at 812 & n.6.

[59]*Id.*

[60]*Graham*, 188 A.2d at 130. *See also* Arsht, *supra* note 37, at 653 (claiming Delaware breach of fiduciary duty cases are determined on a factual basis rather than by standards); Veasey & Manning, *supra* note 56, at 928 (stating that an outcome-determinative factor has not been identified because the cases are narrowly decided on "facts peculiar to each case").

substantive due care.[61] It is also important to remember that in a "due care" analysis, courts are less willing to examine the merits of a decision involving the "business" of the corporation than a decision involving control of the corporation or termination of a derivative suit.[62] In any event, when the directors make a decision, courts will not provide business judgment rule protection to that decision if they find the directors were grossly negligent.[63]

3. Need for a Business Decision

In order for the business judgment rule to apply, directors must "make a business judgment authorizing the transaction under review."[64] Similarly, directors receive the rule's protection if they make "a conscious decision to refrain from acting."[65] However, if the directors "abdicate[ ]

---

[61]This statement is illustrated in the derivative lawsuit context. In a derivative lawsuit, the plaintiff shareholder must either make demand on the board to bring the lawsuit or show that it is excused. *Speigel*, 571 A.2d at 773. In assessing whether demand is excused under a procedural due process claim, the court looks at the independence of the board, the reasonableness of their investigation, and their good faith. *Id.* at 777. Demand has been excused where the directors did nothing but vote for the transaction, *In re* NVF Co. Litig., No. 9050, 1990 Del. Ch. LEXIS 167, at *8-11, and where a new board assumed control and immediately achieved approval for a series of allegedly wasteful transactions. Harris v. Carter, 582 A.2d 222, 229 (Del. Ch. 1990). Because the standard is gross negligence, however, the majority of plaintiffs alleging demand futility based on failure to exercise due care do not succeed. *See, e.g.*, *Levine*, 591 A.2d at 207 (where only 2 of 14 outside directors had misimpressions about the transaction); *id.* at 214 (board failed to allow stockholder to make oral presentation); *Grobow*, 539 A.2d at 191 (plaintiff failed to allege the board did not (i) inform themselves of all available information, (ii) consult experts, (iii) provide adequate notice to all board members, or (iv) inquire adequately into reasons for the transaction); *Pogostin*, 480 A.2d at 627 (board properly and prudently exercised its managerial discretion in rejecting takeover offer); *Andreae*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,571, at 92,653, *reprinted in* 18 DEL. J. CORP. L. at 214 (board allowed to exercise discretion in operational decisions); Decker v. Clausen, Nos. 10,684 & 10,685, 1989 Del. Ch. LEXIS 143, at *12 (Del. Ch. Nov. 6, 1989), *reprinted in* 15 DEL. J. CORP. L. 1022, 1030 (1990) (although plaintiff was "close" to pleading demand futility, the argument would not stand where negligence was that of corporation's subsidiary); *Stein*, No. 7276, 1985 WL 21136, at *3, *reprinted in* 11 DEL. J. CORP. L. at 317 (plaintiff failed to allege majority of directors were beholden to the defendant); Scopas Technology v. Lord, No. 7559, 1984 WL 8266, at *4 (Del. Ch. Nov. 20, 1984), *reprinted in* 10 DEL. J. CORP. L. 306, 312 (1985) (demand futility cannot be based on inaction if there is no opportunity to act; hence, allegation that judgment of the full board was not brought to bear was insufficient).

[62]Veasey & Seitz, *supra* note 37, at 1486; *supra* note 38.

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

[64]Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971).

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

their functions, or absent a conscious decision, fail[ ] to act," the business judgment rule no longer applies.[66]

In *Aronson v. Lewis*,[67] Justice Moore noted that previous cases in Delaware involving abdication and failure of the board to act were wrongly decided on business judgment grounds.[68] However, the opinion did not state how the cases should have been decided.[69] As a result, courts and commentators speculated as to the standard which applies in the absence of a business decision.[70] The following section discusses the debate over the proper standard in the oversight context. Before discussing the debate, however, it is important to understand the directors' duty of oversight.

B. *Director Oversight*

1. Duty of Oversight

The dominance of the business judgment rule,[71] which protects the directors' decision-making function, overshadows the equally important function of the board to oversee corporate affairs.[72] The duty of oversight, however, has not been clearly articulated by the Delaware judiciary.[73] Although *Graham v. Allis-Chalmers*[74] involved allegations of oversight,[75] one cannot be certain that the duty of oversight framed by the

---

[66]*Id.*

[67]473 A.2d 805 (Del. 1984).

[68]*Id.* at 813 n.7. Justice Moore referred to Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963); Kelly v. Bell, 254 A.2d 62 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. 1970); and Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961).

[69]The issue was not before the court in *Aronson*. In *Aronson*, the derivative plaintiff challenged the board's approval of an employment agreement between the company and a retiring director and the board's approval of interest-free loans to the same director. *Aronson*, 473 A.2d at 809.

[70]*See infra* notes 105-30 and accompanying text.

[71]*See supra* note 25 and accompanying text.

[72]*See* Veasey & Seitz, *supra* note 37, at 1501 (stating oversight is the second principal function of the board). One author has suggested that the line between the duty of decision making and the duty of oversight is blurred. Roswell B. Perkins, *Avoiding Director Liability*, HARV. BUS. REV., May/June 1986, at 10. However, he notes that there are important differences between the two functions. *Id.* This article follows the latter reasoning and discusses the duties separately.

[73]*See* Veasey & Seitz, *supra* note 37, at 1501.

[74]188 A.2d 125 (Del. 1963).

[75]*Id.* at 128. In *Graham*, Allis-Chalmers Manufacturing Company engaged in the manufacture of electrical equipment. *Id.* The company was extremely large, employing over 30,000 people and operating 24 plants. *Id.* The company was structured in hierarchical

Graham court still applies today. One reason is that the *Graham* court set forth two different standards governing the duty of oversight. First the court stated, "[I]t appears that directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."[76] Then, three paragraphs later, the court adopted a stricter standard: "[The board may not] recklessly repose[ ] confidence in an obviously untrustworthy employee, . . . refuse[ ] or neglect[ ] cavalierly to perform [their] duties as . . . director[s], or . . . ignore[ ] either willfully or through inattention obvious danger signs of employee wrongdoing . . . ."[77] Later, in *Cede & Co. v. Technicolor, Inc.*,[78] the Delaware Supreme Court, in *dicta*, indicated that there had been no satisfactory resolution of "what[ ] the *Graham* standard may be."[79] There is even less reason to rely on *Graham* in light of the comment in *Aronson* that *Graham* was wrongly decided.[80]

However, a study of the Delaware director oversight cases --including *Graham*--reveals that two key concepts play a role in the determination of whether directors have violated the undefined duty of

---

fashion, with the function of the board confined to making broad policy decisions. *Id.* In 1937, the company was warned by the Federal Trade Commission not to engage in price fixing. *Id.* at 129. Several management personnel, who later became members of the board, learned of the warnings in the 1940s and 1950s, but satisfied themselves that the company no longer had a problem. *Id.* In 1959, company management and the directors, none of whom had served in that capacity in 1937, were indicted. *Id.* at 128. The indictments charged that as early as 1956, company personnel had engaged in price fixing. *Id.* The board did not learn of the government's intentions until 1959, when the story of the government investigations broke in the press. *Id.* Shortly thereafter, the board, with the assistance of counsel, issued policy statements with respect to price fixing. *Id.* at 129. Shareholders of the company sued derivatively to recover damages on behalf of the company connected with the illegal activity. *Id.* at 127. The court held that the directors were not liable. *Id.* at 130. While the court wavered on the appropriate standard of care, see *infra* text accompanying notes 76-77, it felt confident that the board had properly relied on management reports. *Graham*, 188 A.2d at 130. With respect to the allegation that the directors should have established a compliance program, the court replied that the board was not required "to assume, with no justification whatsoever, that all corporate employees are incipient law violators" that needed a "tight checkrein." *Id.* at 130-31.

[76]*Graham*, 188 A.2d at 130.

[77]*Id.*

[78]634 A.2d 345 (Del. 1993).

[79]*Id.* at 364 n.31.

[80]*Aronson*, 473 A.2d at 813 n.7. However, if one compares the language of the second standard in *Graham* with Justice Moore's description of when the business judgment rule applies, it is clear that directors may not abdicate their functions or ignore obvious signs of danger. The question remains open, however, as to the degree of abdication required before liability will be imposed.

oversight. These concepts are the delegation of responsibility[81] and reliance on information presented to the board.[82] Both of these concepts are codified in Delaware General Corporation Law.[83]

Sections 141(a) and (e) of the Delaware General Corporation Law permit boards of directors to delegate authority to, and rely on information received from, officers and employees of the company.[84] Section 141(a) provides, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[85] The statute recognizes that "the director's role is formulating policy and directing officers to conduct the day-to-day operations."[86] A board of directors may also form and give full authority to a committee comprised of board members to carry out the functions of the board.[87] Thus, with respect to the duty of care, a director may avoid liability provided the board has made a valid delegation of its responsibilities to an officer, committee, or employee.[88]

---

[81]*Graham*, 188 A.2d at 128, 130 (directors policy of delegation consistent with magnitude of enterprise); *Kelly*, 254 A.2d at 72 (sheer size required delegation). *See also Rabkin*, No. 7547, slip op. at 6, *reprinted in* 13 DEL. J. CORP. L. at 1217 (directors not expected to know day-to-day operations of a business).

[82]Cheff v. Mathes, 199 A.2d 548, 556 (Del. 1964) (no director oversight when some directors, though not themselves informed, relied on information received from other directors and were therefore entitled to business judgment rule); *Graham*, 188 A.2d at 130 (directors entitled to rely on reports concerning antitrust matters); *Decker*, Nos. 10,684 & 10,685, 1989 Del. Ch. LEXIS 143, at *11-12, *reprinted in* 15 DEL. J. CORP. L. at 1029-30 (parent may rely on subsidiary to oversee activities of subsidiary); *see also Rabkin*, No. 7547, slip op. at 6, *reprinted in* 13 DEL. J. CORP. L. at 1217 (directors not expected to know day-to-day operations of a business).

[83]DEL. CODE ANN. tit. 8, § 141(a), (e) (1991).

[84]*Id.*

[85]*Id.* § 141(a).

[86]1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.8, at 4-193 (quoting General Corporation Law Committee of the Delaware State Bar Association).

[87]DEL. CODE ANN. tit. 8, § 141(c) (1991). There are certain exceptions to the power of the board to delegate its authority to a committee. For instance, the board may not give a committee the power to amend the certificate of incorporation, adopt a merger agreement, recommend to the stockholders the sale of all of the corporate assets, recommend dissolution, or recommend an amendment to the bylaws. *Id.*

[88]*See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) (stating that "[a]n informed decision to delegate a task is as much an exercise of business judgment as any other"); *see also* Veasey & Seitz, *supra* note 37, at 1502 (stating that directors will be protected if they consciously decide to delegate responsibility to reliable subordinates).

Section 141(a) should be read together with section 141(e) which provides a reliance defense to directors whose decisions are challenged for want of due care:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying on good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.[89]

Section 141(e) constitutes legislative recognition of the fact that directors cannot possibly know everything about the corporation or a particular transaction.[90] The connection with the duty of care standard of gross negligence is rather obvious: directors who are informed with respect to a given transaction, but for the misinformation provided by an officer or other corporate personnel, will not be held responsible for the adverse consequences of that transaction.[91]

The significance of these concepts in the oversight context cannot be overstated. Directors who can hang their hats on these defenses will not be found liable for damages resulting from oversight. Indeed, the only case in Delaware which imposed liability in the director oversight

---

[89]DEL. CODE ANN. tit. 8, § 141(e) (1991).

[90]*See* 1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.7, at 4-172.

[91]*See supra* note 75 (discussing *Graham* in detail). Of course, what the directors rely on must be considered a report. *See Van Gorkom*, 488 A.2d at 875. "Report" is a term of breadth in Delaware law. *Id.* (stating "report" is liberally construed). However, to meet the definition of a report under § 141(e), the oral or written presentation "must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind, reliance." *Id.* The report will probably be entitled to good faith reliance when the person making the report is informed. *See id.* It is unclear from the court's analysis of Van Gorkom's oral presentation to the board whether the court was holding Van Gorkom to a duty of care standard to be informed in concluding that Van Gorkom was uninformed about the merger agreement. *Id.* The court only stated that Van Gorkom was "basically uninformed as to the essential provisions of the very document about which he was talking." *Id.*

context, *Lutz v. Boas*,[92] did so because the outside directors completely abdicated their responsibilities and exercised no oversight at all.[93]

Lutz provides a good summary of the duty of oversight and the debate which it entails. *Lutz* involved, *inter alia*, a claim against the outside directors of Managed Funds, Inc. (Funds), a mutual fund company.[94] The founders of Funds, the Slaytons, caused Funds to contract with their wholly-owned investment advisory company, Slayton Associates, Inc. (Associates), for investment services.[95] The Slaytons then caused Associates to contract with an employee of the Model, Roland & Stone brokerage firm (Model), Stephen Jacquith (Jacquith).[96] Associates, without the authority to do so, put Jacquith in charge of managing Funds.[97] Having done so, the Slaytons proceeded to (1) collect from Funds for services they did not render;[98] (2) pay, on behalf of Funds, commissions to Model when Funds had not authorized Model to give it advice;[99] and (3) churn the accounts of Funds in contravention of Funds' stated investment policy and the Investment Company Act, thereby producing excessive commissions.[100] The outside directors were found liable for failing to detect these illegal activities.[101]

Lutz offers several different perspectives on the duty of oversight. First, one can argue that the outside directors were held liable because they pushed the limit of the delegation and reliance doctrines by deferring all of their responsibility to the inside directors, the Slaytons. Second, one could argue, as the court of chancery did, that the outside directors were liable because they were grossly negligent.[102] The court applied a tort analysis, stating that the directors' failure to give any attention to their duties was the proximate cause of the various losses to Funds.[103] Finally, in light of the fact that no Delaware decision has imposed liability in the oversight context, one could say that *Lutz* stands for the proposition that directors will be found liable in the oversight context

---

[92]171 A.2d 381 (Del. Ch. 1961).
[93]*Id.* at 396.
[94]*Id.* at 383-84.
[95]*Id.*
[96]*Lutz*, 171 A.2d at 385.
[97]*Id.* at 387.
[98]*Id.*
[99]*Id.* at 388.
[100]*Lutz*, 171 A.2d at 393.
[101]*Id.* at 395-96.
[102]*Id.* at 396.
[103]*Id.*

only when they completely abdicate their responsibilities to the corporation and the shareholders.[104] The possible variations on *Lutz* illustrate the divergent views which commentators take in the debate over the proper standard in the oversight context.

2. Director Oversight: The Debate Over the Applicable Standard

The commentators, while focusing on many of the same cases, do not agree on what standard governs (or should govern) directorial action in the absence of a business decision. Vice-Chancellor Berger, now Justice Berger, who was forced to resolve the debate in *Rabkin v. Phillip A. Hunt Chemical Corp.*,[105] noted that "[d]ifferent commentators have relied upon the *Allis-Chalmers* decision in reaching opposite conclusions as to the appropriate standard of care."[106] In defining the relevant standard of care, some commentators argue that a negligence standard applies; others, gross negligence; and still others reject tort concepts altogether. Despite the divergent points of view, commentators expressly or implicitly agree that courts only impose liability for oversight when the directors have abdicated their responsibilities altogether. The respective analyses are briefly explored here.

S. Samuel Arsht, discussing Delaware law in 1979, believed that under *Graham*, the "ordinarily prudent person in similar circumstances" test controlled in cases where the directors did not make a business decision.[107] While discussing when the business judgment rule did not apply, Arsht indicated in what situations he believed directors might be liable under this negligence standard.[108] To Arsht, the proper application of the business judgment rule required the director to pay "informed attention to his duties. A director cannot close his eyes to what is going

---

[104]Indeed, many have argued this same point. *See infra* text accompanying notes 107-30.

[105]No. 7547 (Del. Ch. Dec. 17, 1987), *reprinted in* 13 DEL. J. CORP. L. 1210 (1988).

[106]*Id.*, slip op. at 4, *reprinted in* 13 DEL. J. CORP. L. at 1215. The court eventually settled on a negligence standard. *Id.*, slip op. at 6-8, *reprinted in* 13 DEL. J. CORP. L. at 1216-17. *But see* Boeing Co. v. Shrontz, No. 11,273, 1992 Del. Ch. LEXIS 84, at *13-14 (Del. Ch., Apr. 20, 1992), *reprinted in* 18 DEL. J. CORP. L. 225, 235-36 (1993) (applying gross negligence test).

[107]Arsht, *supra* note 37, at 659 & n.24. Indeed, he believed that the business judgment rule was ultimately based on the law of torts. *Id.* at 661. According to Arsht, "The Business Judgment Rule extends to directors only the same necessary protection that professional persons, doctors, lawyers, architects, engineers, enjoy under the Anglo-American Tort Law if sued for malpractice." *Id.*

[108]*Id.* at 660-61.

on about him in the conduct of a corporate business and have it said he is exercising business judgment."[109] Thus, abdication of duty, rather than negligent conduct, seemed to serve as the basis for liability under Arsht's reading of the cases.

Charles Hansen joined Mr. Arsht in his conclusion that the ordinary prudent person standard applied in the nondecision-making context.[110] He believed this negligence standard was "closer to reality."[111] However, Mr. Hansen believed that despite judicial reliance on the ordinarily prudent person standard, the actual due care standard was less stringent.[112] His interpretation of the case law suggested that courts had only imposed liability on directors when they had expressly abdicated their duties or demonstrated "patterns of exacerbated neglect."[113]

E. Norman Veasey, now Chief Justice Veasey, opined, as a member of the Delaware bar, that *Graham* and *Lutz* supported a gross negligence standard in the oversight context.[114] He believed that *Graham*

---

[109]*Id.* at 660. Arsht would also require that the directors have no personal interest in the transaction. *Id.*

[110]Hansen, *supra* note 32, at 1359. Block, Barton, and Radin also agree that the duty of care formulation is ordinary negligence. BLOCK ET AL., *supra* note 25, at 58-59 (citing *Graham*). The authors likewise share Mr. Hansen's interpretation that the courts look to see whether the board "failed to pay *any* attention to corporate business" before imposing liability. *Id.* at 72-73.

[111]Hansen, *supra* note 32, at 1359. Unfortunately, Mr. Hansen did not explain what he meant by "closer to reality." *See id.* In light of Mr. Arsht's comments that the business judgment rule protects directors like any other professional, it is possible that it is this meaning which Mr. Hansen intended by his remark.

[112]*Id.*

[113]*Id.*; *see also* BLOCK ET AL., *supra* note 25, at 72-73 (observing that liability has been imposed for failure to act in cases other than *Van Gorkom* where directors have "failed to pay *any* attention to the corporate business"). Mr. Hansen identified Rabkin v. Phillip A. Hunt Chem. Corp., No. 7547 (Del. Ch. Dec. 17, 1987), *reprinted in* 13 DEL. J. CORP. L. 1210 (1988), as the only case which *might* have imposed liability for a single omission. Hansen, *supra* note 32, at 1360 n.30.

[114]Veasey & Seitz, *supra* note 37, at 1503. Mr. Veasey reached the same conclusion five years earlier. *See* Veasey & Manning, *supra* note 56, at 928. However, he noted that the courts and commentators had been unable to reach a uniform definition of gross negligence. *Id.* Rather, the cases were determined by their facts irrespective of the standard set forth by the court. *Id.* Mr. Veasey's analysis is nearly identical to that of Messrs. Balotti and Finkelstein. 1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.8, at 4-196 to 4-204. Balotti and Finkelstein concluded in a more definitive fashion, however:

> The *Graham* ("red flag") test is still good law. Gross negligence is probably the law of Delaware in the oversight context as well as the standard for the informed basis/due care test in decision making. Whether the Delaware courts would today impose liability only for "prolonged inattention" or " abdication" in the oversight context might depend upon the facts of a given situation.

established a "red flag" test under which directors would be liable when they ignored "obvious danger signs" or otherwise acted in a reckless or cavalier manner.[115] In discussing the gross negligence/red flag test, Mr. Veasey noted the Second Circuit's decision in *Joy v. North*,[116] where the court rejected a tort-based analysis in the director oversight context.[117] Justice Veasey, writing extra-judicially, observed that the *Joy* court believed it was better to focus on whether the board demonstrated an "obvious and prolonged failure to exercise oversight or supervision."[118] Mr. Veasey admitted that the Delaware "cases do not so hold but leave room for such an argument."[119]

Other authors reject the attempt to apply tort concepts in the director oversight context. In 1984, Bayless Manning boldly proclaimed that current formulations of the duty of care "lead only to undesirable social consequences and ultimately to a dead-end of unworkability."[120] In particular, Manning attacked duty of care formulations predicated on tort concepts.[121] He believed tort concepts were inappropriate because, unlike driving a car for example, the work of directors is not easily defined and lacks a common standard with respect to how it should be done.[122] In addition, his analysis revealed that directors rarely make an affirmative decision which would have the protection of the business judgment rule; rather, directors engage in "a continuing flow of supervisory process."[123]

Manning proposed a standard incorporating his views which he dubbed the "duty of attention."[124] Under this standard, "a director of a

---

Id. at 4-204.

[115]Veasey & Seitz, *supra* note 37, at 1502-03.

[116]692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

[117]Veasey & Seitz, *supra* note 37, at 1502.

[118]*Id.* (citing *Joy*, 692 F.2d at 884, *cert. denied*, 460 U.S. 1051 (1983)).

[119]*Id.*

[120]Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time For Reality*, 39 BUS. LAW. 1477, 1478 (1984). The title, "Time For Reality," exemplifies Mr. Manning's attempt to get lawmakers to examine precisely what directors do before imposing standards of liability on them. In this regard, he addressed the "real world conduct of directors," looking at such factors as the amount of time devoted, the complexity of the enterprise, pace and deliberation, uncertainty and risk-taking, diversity of the board, the decisional process, the character of the agenda, agenda-setting, actions not taken, homework, attendance, reliance, depth of inquiry, and judgment. *Id.* at 1481-92. The article did not cite a single case.

[121]*Id.* at 1493-95.

[122]*Id.* at 1493-94.

[123]*Id.*

[124]Manning, *supra* note 120, at 1499.

company [was required to] devote to the affairs of the company and the performance of his duties as a director such attention as, in his good-faith business judgment, a responsible and diligent director similarly situated should devote thereto in the circumstances."[125]

Professor Donald Pease, commenting on *Aronson*, echoed the sentiments of Manning.[126] Pease observed that the *Aronson* court's decision to associate the duty of care standard "with concepts of gross negligence" raised two important issues. First, Pease believed it was unnecessary for the *Aronson* court to elaborate on the duty of care standard because it did not bear upon whether demand was excused under the facts in *Aronson*.[127] Second, Pease argued that tort standards were not useful in defining the duty of care because there is a "difference between negligence and a director's duty of care."[128] Professor Pease, like Dean Manning, framed the issue as whether the directors had breached their obligation to give their "attention to the business of the company."[129]

In summary, the commentators split on whether tort concepts were appropriate in defining the standard of care. Those that believed tort concepts were appropriate further divided on the issue of whether the proper standard was negligence or gross negligence. Common to all of the analyses, however, was the observation that the standards provided little guidance in determining the outcome of a director oversight case.[130] Rather, liability was imposed in extreme circumstances, where the directors had abdicated their responsibilities altogether. Although the commentaries did not always focus on the board's rights to delegate responsibility and rely on information from subordinates, this author argues that these concepts impacted the conclusions of the commentators. The next section concludes, however, that post-*Graham* developments in the business world will bear on the board's right to delegate and rely on others in the future.

---

[125] *Id.*

[126] Donald E. Pease, Aronson v. Lewis: *When Demand Is Excused and Delaware's Business Judgment Rule*, 9 DEL. J. CORP. L. 39 (1984).

[127] *Id.* at 70. Pease speculated that the court defined the duty of care standard in order to end the apparent confusion of the chancery court over which standard was the proper one. *Id.*

[128] *Id.* at 72.

[129] *Id.* at 71.

[130] Non-legal commentators shared this view as well. *See* Perkins, *supra* note 72, at 8.

C. *Modern Directing: New Challenges*

In the corporate world, refusal to change past practices can impede strategic change.[131] In the legal world, failure results when judges and advocates cling to *stare decisis* and blindly apply standards which bear no relation to the world which they seek to judge.[132] As the social, political, and economic environments shift, so must the legal standards by which we judge the actors.

The environment in which the modern board of directors operates is changing. In 1963, the year in which *Graham* was decided, large, hierarchical structures predominated.[133] Management, not the board of directors, played the more significant role in running the affairs of the corporation.[134] In the words of one commentator, boards were mere "parsley on the fish."[135] The corporate super-structure and the relative passivity of the board impacted the development of corporate law, giving way to the ideas of delegation and reliance.[136]

Corporate scandal and America's slip from its role as world leader generated new thinking in corporate America.[137] Corporations needed planners and persons with integrity and business skills to guide them through an ever-growing competitive environment.[138] The shift of control

---

[131]GORDON DONALDSON & JAY W. LORSCH, DECISION MAKING AT THE TOP 8 (1983). The authors contended that America's corporate failures are not the result of a short-term focus. *Id.* at 7-8. To the contrary, they found that executives are very concerned with the long term survival of their corporations. *Id.* at 8. Donaldson and Lorsch went on to note that

> in those instances where [corporate leaders] have failed to adapt the company's strategy to a changing competitive environment, the explanation lies not in a short-term focus but rather in their inability to read environmental trends correctly or in their adherence to traditional beliefs about consumer preferences and competitive practices.

Id. But see LEE G. BOLMAN & TERRENCE E. DEAL, MODERN APPROACHES TO UNDERSTANDING AND MANAGING ORGANIZATIONS 298-300 (1984) (suggesting that managers need a commitment to "core beliefs" and flexible thinking to compete); JAGOE, *supra* note 26, at 9-19 (stating that most successful corporations have corporate credo).

[132]*See* Manning, *supra* note 120, at 1480 (stating that scholars and judges feel compelled to rely on existing analysis).

[133]Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV., Mar.-Apr. 1990, at 46, 46.

[134]*Id.* at 47; A.J. Vogl, *Who's Watching the Watchers?*, *in* ACROSS THE BOARD, Nov. 1993, at 23 (interview with corporate lawyer Ira Millstein).

[135]Vogl, *supra* note 134, at 24.

[136]Veasey & Manning, *supra* note 56, at 924-25 (discussing the relationship between the *Graham* decision and § 141(a) of the Delaware General Corporation Law).

[137]Vogl, *supra* note 134, at 24.

[138]*Id.* at 25.

from management to the board ensued.[139] While the shift in power continues, so does the arrival of new challenges. The complexity which boards face in running a large corporation is currently compounded by new government regulation, new competition, and new information resources.

Government regulation is everywhere.[140] In addition to the antitrust[141] and securities laws,[142] which arose in the early part of the century, directors now face liability for environmental clean-up,[143] racketeering activity,[144] and acts of corruption committed by corporate

---

[139]*Id.*

[140]*See* BOLMAN & DEAL, *supra* note 131, at xiii (recognizing that "corporate managers face a diverse and often bewildering array of government actions, interventions, and regulations"); *see also* Perkins, *supra* note 72, at 8 (arguing that in the last decade, the pressure on boards to perform rose because the government increasingly "focus[ed] on the board of directors as the vehicle for ensuring compliance with the . . . standards"). The Foreign Corrupt Practices Act, and the environmental, securities, and banking laws are examples of the "tighter legal requirements for which boards are now responsible." *Id.*

[141]The antitrust laws are comprised of many separate acts. The Sherman Act is designed to prevent restraints on trade, monopolization, and attempts to monopolize by imposing criminal penalties on both corporations and individuals. 15 U.S.C. § 1 (1988 & Supp. V 1993), § 2 (1988). The Clayton Act prohibits mergers, which tend to lessen competition or create a monopoly, *id.* § 18, and exclusive dealing. *Id.* § 14. The Clayton Act contains both a private civil remedy to those injured in their business by reason of acts precluded by the antitrust laws, *id.* § 15, and with the addition of the Hart-Scott-Rodino Antitrust Improvement Act of 1976, a civil penalty against officers and directors who fail to comply with the pre-merger notification and waiting period requirements. *Id.* § 18(g)(2). The Clayton Act also contains the Robinson-Patman Act, which prohibits price discrimination in its many forms. *Id.* § 13. Violations of the Robinson-Patman Act are likewise subject to the civil damage remedy. *Id.* § 15. Congress also created the Federal Trade Commission, whose mission is to prevent the use of unfair methods of competition. *Id.* § 45.

[142]The securities laws consist primarily of The Securities Act of 1933, 15 U.S.C. § 77a-77z (1988 & Supp. V 1993), and The Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78*ll* (1988 & Supp. V 1993). Generally speaking, the 1933 Act imposes civil and criminal liability for fraudulent acts involving the initial registration and distribution of securities, while the 1934 Act imposes civil and criminal liability for fraudulent market manipulation. The Williams Act was added to the 1934 Act in order to prevent manipulation and fraud in proxies and tender offers. 15 U.S.C. § 78n (1988 & Supp. V 1993).

[143]The biggest threat to directors for environmental concerns derives from the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). *See* 42 U.S.C. §§ 9601-9675 (1988 & Supp. IV 1993). CERCLA seeks to recover on behalf of the government the costs associated with environmental cleanup. *Id.* § 9607. The Act permits recovery from almost any person associated with the hazardous substances at issue. *Id.* Directors are generally held liable only when they are directly involved in the actual environmental violations. Cindy A. Schipani, *Integrating Corporate Law Principles With CERCLA Liability for Environmental Hazards*, 18 DEL. J. CORP. L. 1, 5-10 (1993).

[144]Perhaps the greatest threat to a director's insurance coverage is the Racketeer Influenced and Corrupt Organizations Act (RICO). 18 U.S.C. §§ 1961-1968 (1988 & Supp.

personnel in foreign countries.[145] Directors of lending institutions are additionally liable for unpaid loans to insiders and loans which exceed the institution's lending limits.[146] To add to their worries, directors of federally insured banks which enter receivership currently face liability for the unfortunate consequences of their grossly negligent decisions.[147]

V 1993). While not regulation per se, the act imposes civil and criminal liability on any person who conducts or participates in an enterprise's affairs through a pattern of racketeering activity. *Id.* § 1962(c). Although originally intended to deter organized crime, the act became the darling of plaintiffs' attorneys who sought to benefit from RICO's treble damages provision in securities and other lawsuits. *See* Christopher D. McDemus, Comment, Reves v. Ernst & Young: *The Supreme Court's Recent Restrictive Standard Concerning § 1962(c) of the Civil RICO Statutes*, 19 DEL. J. CORP. L. 1027, 1028-29 (1994); 18 U.S.C. § 1964(c) (1988 & Supp. V 1993). Currently, the Supreme Court is only willing to impose civil RICO liability on those who operate or manage the affairs of an enterprise. Reves v. Ernst & Young, 113 S. Ct. 1163, 1173 (1993); McDemus, *supra*, at 1953-54. This holding does little, of course, to save directors and officers, who clearly operate and manage the corporation.

[145]The Foreign Corrupt Practices Act of 1977, amended in 1988 by Pub. L. No. 100-418, prohibits domestic corporations from influencing foreign officials through bribery and other illegal means. 15 U.S.C. § 78dd-2 (1988). Officers and directors face civil and criminal liability regardless of whether they willfully violated the statute. *Id.* In addition, the corporation may not indemnify the officer or director for the fines which the Act imposes. *Id.*

Directors must also contend with corruption at home. It is estimated that white collar criminals steal $200 billion annually. JAGOE, *supra* note 26, at 165. Jagoe recommends that managers "[p]ay special attention to computer fraud. Once the computer becomes an accomplice, theft may become almost impossible to discover." *Id.* at 164. Recently, the investment companies of Prudential Bache and Kidder, Peabody were forced to admit that their employees had engaged in fraudulent activities which overstated the profitability of certain departments. Douglas Frantz, *The Ghost in Kidder's Money-Making Machine*, N.Y. TIMES, Apr. 29, 1994, at D1, D4; Leah Spiro, *Why Didn't Kidder Catch On?*, BUS. WK., May 2, 1994, at 121.

[146]Loans to insiders, *i.e.*, directors, officers, their immediate families, and their related interests, are governed by Regulation O. 12 C.F.R. § 215 (1994). Directors can be held personally liable for such unpaid loans. *Id.* Directors can also be held liable for exceeding the lending limits set forth in 12 U.S.C. § 84 (1983). Del Junco v. Conover, 682 F.2d 1338 (9th Cir. 1982), *cert. denied*, 459 U.S. 1146 (1983).

Regulations complicate the task of managing a financial institution:

> The hard reality is that contemporary banking is profoundly complex. Indeed, even *trained bank examiners* sometimes fail to competently decipher emerging bank problems, and trained resolvers sometimes fail to properly salvage insolvent institutions' remaining assets. Thus, if professional bank examiners, who are hired, trained and paid to conduct "reasonable inquiry," occasionally fail in their efforts because of their industry's complexity, then the difficulties facing inexperienced bank directors . . . are likely to be far more overwhelming.

David B. Fischer, Comment, *Bank Director Liability Under FIRREA: A New Defense for Directors and Officers of Insolvent Depository Institutions--Or A Tighter Noose?*, 39 U.C.L.A. L. REV. 1703, 1735-36 (1992) (footnotes omitted).

[147]Among the new regulations facing banks is the Financial Institutions Reform,

Each of these regulations exposes directors to a host of civil and criminal sanctions.[148]

Global competition has also impacted the role of the modern board. Corporations have shed layers of their hierarchical structures to meet the demands of the world economy.[149] In addition, directors have begun emphasizing their policy and oversight function with greater vigor to meet foreign competition.[150] Today, there is almost unanimous agreement that the board's oversight function begins with the chief executive officer (CEO).[151] Today's commentators also agree that board dynamics should

---

Recovery and Enforcement Act (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified as amended in scattered sections of 12 U.S.C.). FIRREA was enacted to cure the ills associated with the savings and loan crises of the 1980s. Fischer, *supra* note 146, at 1705; Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J. CORP. L. 739, 743 (1992). Under FIRREA, directors whose banks fall into receivership face liability for their acts of gross negligence. 12 U.S.C. § 1821(k) (Supp. V 1993). However, the FDIC has asserted that where state law so permits, it may proceed against bank directors for their acts of negligence. Schipani, *supra*, at 743. The Tenth Circuit supports the FDIC's position. FDIC v. Canfield, 967 F.2d 443 (10th Cir. 1992), *cert. dismissed*, 113 S. Ct. 516 (1993).

[148]*See supra* notes 141-47.

[149]Johnson, *supra* note 133, at 48. Johnson noted that "many big corporations are considering divestment or decentralization of operations that can be carried out less expensively and more flexibly by autonomous suppliers." *Id.* Similarly, in a text reporting on the impact of information technology on the future corporation, Michael S. Morton predicts that global competition will cause an "evolution away from the traditional hierarchical organization." MICHAEL S. MORTON, *Introduction* to THE CORPORATION OF THE 1990S, at 3, 8-9 (Michael S. Morton ed., 1991). However, not everyone is of the view that downsizing is necessary to compete. John A. Byrne, *The Pain of Downsizing*, BUS. WK., May 9, 1994, at 60, 61 (suggesting downsizing may be a fad intended to please Wall Street investors). *But see* John A. Byrne, *There is an Upside to Downsizing*, BUS. WK., May 9, 1994, at 69 (noting positive effects of downsizing).

[150]*See* Clifton R. Wharton Jr. et al., *Advice and Dissent: Rating the Corporate Governance Compact*, HARV. BUS. REV., Nov.-Dec. 1991, at 136, 137; Vogl, *supra* note 134, at 24.

[151]Johnson, *supra* note 133, at 54; Vogl, *supra* note 134, at 24; Wharton Jr. et al., *supra* note 150, at 137, 142; George Anders, *The "Barbarians" in the Boardroom*, HARV. BUS. REV., July-Aug. 1992, at 79, 81. The Working Group on Corporate Governance's New Compact for Owners and Directors attempted to resolve the differences between the directors and the new breed of owner, the institutional investor. Wharton Jr. et al., *supra* note 150, at 136. The Working Group proposed that the outside directors evaluate the performance of the CEO against established goals and strategies. *Id.* In addition to monitoring the CEO, the Working Group recommended that the outside directors meet alone once a year and that the board establish qualifications for board membership. *Id.* The Group also recommended that institutional investors change their behavior. *Id.* Specifically, the Working Group recommended that (1) institutional investors view themselves as owners, not just investors; (2) shareholders should not be involved in the day-to-day affairs of the company; (3) shareholders should evaluate the directors; (4) shareholders should be informed; and (5) shareholders should

change. The outside directors are expected to play a more dominant role.[152] One commentator observed, "Companies are looking beyond the old boys' network for individuals to serve on the board of directors."[153]

Information technology (IT) is the third, and perhaps most important element of change.[154] IT includes such terms such as hardware, software, networks, work stations, robotics, and smart chips.[155] IT has been described as the "information engine," capable of revolutionizing business as did the steam engine during the Industrial Revolution.[156] Most importantly, IT has the potential to impact the traditional structures of organizations and the ways organizations are managed.[157] In the

---

acknowledge their common goal of continuing prosperity. *Id.*

Not everyone agrees with the trend to be critical of the CEO. *See* Thomas J. Whisler, *Some Do's and Don'ts for Directors*, WALL ST. J., Feb. 21, 1983, at 23 (cautioning boards to support the CEO and not give too much criticism). Other authors suggest that the role of the directors is to monitor not just the CEO, but management. *Id.*; William A. Sahlman, *Why Sane People Shouldn't Serve on Public Boards*, HARV. BUS. REV., May-June 1990, at 28, 28. Sahlman believes directors should monitor management but also help them to maximize value for the shareholders. *Id. But see* Charles R. Schwenk, *Devil's Advocacy and the Board: A Modest Proposal*, BUS. HORIZ., July-Aug. 1989, at 22, 22 (suggesting boards are ineffective overseers).

[152]Vogl, *supra* note 134, at 24; Wharton Jr. et al., *supra* note 150, at 136 (discussing Working Group on Corporate Governance's proposal that the outside directors should monitor the CEO and should meet alone once a year); *see* Charles E. Barnett et al., *Director's Fraud Often a Sin of Omission*, CORP. LEGAL TIMES, Feb. 1994, at 1, 9 (comments of Joseph D. Hansen, discussing proper role of outside directors); Sanford L. Jacobs, *A Well-Chosen Outside Board Gives Owners Peace of Mind*, WALL ST. J., Jan. 21, 1985, at 25. *But see* Wharton Jr. et al., *supra* note 150, at 142 (comments of Lord Hanson) (cautioning against "two-tier" board comprised of inside and outside directors). Outside directors are not necessarily inexperienced. *See* Alex Taylor III, *The Odd Eclipse of a Star CEO*, FORBES, Feb. 11, 1991, at 86, 88 (discussing qualifications of Ford's outside directors); Jacobs, *supra*, at 25 (noting outside directors can bring expertise and experience inside directors lack). Outside directors are also not necessarily lapdogs to the inside directors and the CEO. *See* Taylor, *supra*, at 90 (noting outside directors engineered removal of CEO before inside directors were even aware of the plan); Schwenk, *supra* note 151, at 27 (noting RJR-Nabisco board formed independent committee in response to management buyout, even though they were somewhat beholden to CEO).

[153]Nathaniel E. Slavin, *Questions Raised on Need for D&O Insurance*, CORP. LEGAL TIMES, Jan. 1994, at 20. However, some boards have not looked far enough outside the old boys' network to find their outside directors. See Linda Himelstein, *Boardrooms: The Ties That Blind?*, BUS. WK., May 2, 1994, at 112, who notes that some boards have "outside" directors who have professional links to the corporation. The article reported that half of the companies listed in Standard and Poor's stock index have so-called "affiliate directors," non-management directors upon whom the company relied for professional services. *Id.* at 113.

[154]*See* MORTON, *supra* note 149, at 8; Johnson, *supra* note 133, at 48.

[155]MORTON, *supra* note 149, at 4-5.

[156]*Id.* at 8.

[157]*Id.* at 8-9.

twenty-first century, corporations which simply work harder within existing organizational structures will succumb to those that incorporate IT into their strategies.[158]

The Corporation of the 1990s[159] reported on the impact of IT on American corporations. The text offered six major findings, five of which are important here.[160] First, the authors concluded that "IT is enabling fundamental changes in the way work is done."[161] With respect to management, this meant that those responsible for direction of the corporation would be able to stay in close contact with the organization and its members.[162] Second, the authors found that IT would foster "the integration of business functions at all levels within and between organizations."[163] Although the authors found that the infrastructure was not entirely in place to permit complete integration, they noted that "the concept of 'any information, at any time, anywhere, and any way I want to look at it,'" was becoming increasingly feasible.[164] Of course, with integration comes a breakdown of the traditional vertical structure of the corporation.[165] Third, the authors discovered that "IT presents new strategic opportunities."[166] Corporations may save money by automating their operations and reducing the number of workers.[167] Fourth, the authors concluded that "successful application of IT will require changes in management and organizational structure."[168] The bottom line of this study is that firms will become networked and more interdependent.[169] The end result of the networked and interdependent firm appears to be the elimination of middle management and the hierarchical structure.[170]

---

[158]*Id.* at 5; Johnson, *supra* note 133, at 48. Johnson states that "information technology . . . gives small companies equal access to information and reduces transaction costs so greatly that large, hierarchical organizations no longer enjoy their former advantage." *Id.*

[159]MORTON, *supra* note 149.

[160]*See generally* MORTON, *supra* note 149, at 11-21. The finding not discussed here is that IT is causing shifts in the competitive climate of many industries. *Id.* at 14. This study concludes firms will be better linked with competitors and cooperators in their market and will better be able to establish up-to-date performance standards. *Id.* at 14-15.

[161]*Id.* at 11.

[162]*Id.* at 12-13.

[163]*Id.* at 13.

[164]MORTON, *supra* note 149, at 13.

[165]*Id.*

[166]*Id.* at 15.

[167]*Id.* at 16.

[168]MORTON, *supra* note 149, at 17.

[169]*Id.* at 18.

[170]John F. Rockart & James E. Short, *The Networked Organization and the Management of Interdependence*, *in* THE CORPORATION OF THE 1990S, at 189, 204-06 (Michael

Finally, the authors found that leadership is required to undergo the "transformation necessary to prosper in the globally competitive environment."[171] To successfully transform their company, leaders must have a clear corporate vision; align IT, strategy, and organizational dimensions; and have a strong infrastructure.[172]

The three factors discussed above--government regulation, global competition, and information technology--are changing the corporation and, most importantly, the role of the board of directors. As the corporate environment shifts, so must corporate law. Each of the above factors and their impact on the board's role bears on the two critical elements in director oversight liability: delegation and reliance. The next section proposes an analysis for assessing director liability in the oversight context in light of the modern challenges which face boards of directors.

D. *Resolution*

Section II of this article concluded that the observation most common to the analyses of director oversight cases was that directors were not found liable unless they completely abandoned their duties. While most of the analyses suggested that the results were fact-driven, an analysis of statutory law suggests otherwise. Sections 141(a) and (e) of the Delaware General Corporation Law clearly shape the outcome of director oversight cases. When directors delegate responsibility to others and properly rely on information from management or other sources, they are protected from the adverse consequences of that delegation or reliance.[173] This is true even though the business judgment rule may not apply because the directors have not made a decision. Thus, it is only in the obvious case that liability attaches because it is in these cases that the opportunity to assert the defenses of delegation and reliance are not available.

The influence of delegation and reliance in director oversight cases is illustrated by the following analysis: if the directors know of the need for corrective action and decide not to act, they violate a key prerequisite of the business judgment rule: that they act in the *honest* belief that the action taken, or inaction, was in the best interests of the company.[174]

S. Morton ed., 1991).

[171]MORTON, *supra* note 149, at 18.

[172]*Id.* at 20.

[173]DEL. CODE ANN. tit. 8, § 141(e) (1991).

[174]1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.6, at 4-41 to 4-42. The directors'

Likewise, if the directors are wearing the director's hat without actually playing the director's role, they are liable.[175] Neither of these instances provides the opportunity to defend the inaction on the basis of delegation or reliance.[176]

1. Impact of Modern Developments on the Concepts of Delegation and Reliance

In answering the ultimate question, "[w]hat, then, is the standard of care in the oversight context?,"[177] it is necessary to understand the impact of contemporary developments on the concepts of delegation and reliance. Section 141(a) permits the board to directly control the corporation.[178] It states that the corporation can be managed "by" the

---

belief could not be honest because they would be knowingly causing harm to the corporation whose affairs and assets they agreed to protect. *See, e.g.*, *Boeing*, No. 11,273, 1992 Del. Ch. LEXIS 84, at *14, *reprinted in* 18 DEL. J. CORP. L. at 236-37 (applying *Graham* and denying defendants' motion to dismiss where plaintiffs alleged that the directors knew of wrongdoing for an extended period of time but failed to act). Without the business judgment rule, the directors would be forced to prove the entire fairness of their inaction. *Cede*, 634 A.2d at 361. Directors facing the test rarely are able to meet its high standards of fair dealing and fair price. *Weinberger*, 457 A.2d at 710. *But see* Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993) (directors of closely held corporation met entire fairness test).

[175]Clearly, a director cannot delegate all of his responsibility away. *See, e.g.*, *Lutz*, 171 A.2d at 395-96. They must manage the corporation. DEL. CODE ANN. tit. 8, § 141(a) (1993). The word "manage" connotes some active participation. It is defined as a verb meaning "to control and direct: handle either well or ill" and "to treat with care." WEBSTER'S INTERNATIONAL DICTIONARY 1372 (1981). The term "manage" is "[g]enerally applied to affairs that are somewhat complicated and that involve skill and judgment." BLACK'S LAW DICTIONARY 960 (6th ed. 1990).

[176]The same is true if the argument is that the directors should have known of the alleged wrongdoing. In that instance the directors may contend that they properly delegated the responsibility for detecting the wrongdoing to another, or that they were relying on another to give them the necessary information. *See, e.g.*, *Graham*, 188 A.2d at 130. Of course, directors have a duty of reasonable inquiry. Perkins, *supra* note 72, at 11. Perkins notes that "red-flag situations" require that the directors ask tough questions. *Id.*; *see also* 1 BALOTTI & FINKELSTEIN, *supra* note 8, § 4.8, at 4-204 (stating *Graham* established a "red-flag test"); Veasey & Seitz, *supra* note 37, at 1502 (discussing *Graham*'s holding that directors are not liable for failing to discover other directors' misdeeds, unless there were "red flags"). To illustrate the extent of the duty, Perkins hypothesizes about the situations "when there is a sharp change in some crucial corporate operating or financial statistic, . . . or when key employees appear to be leaving the company without an explanation to the board or to the CEO." Perkins, *supra* note 72, at 11. In these situations, it would be difficult for a director to argue that he simply relied on the CEO to tell him when there was a financial or personnel problem.

[177]Veasey & Seitz, *supra* note 37, at 1503.

[178]*See supra* notes 84-88 and accompanying text.

board.[179] It also permits the board to indirectly control the operation of the corporation; the corporation may be operated "under" the board's watchful eye.[180] To the extent the former is possible or actual, there is less need for delegation and reliance.[181] It is clear that the three developments discussed above--regulation, competition, and information--bear on the need for delegation and reliance.

Modern developments make delegation[182] both more and less likely. Delegation is more likely because of the significant amount of legislation which demands corporate and board compliance. Directors cannot simultaneously draft the Form 10-Qs, make sure the sales personnel are not price fixing, and spy on the manager overseas to make sure he is not bribing foreign officials. In short, delegation is a must. The current solution seems to be that directors are responsible for making sure that the proper structure is in place for them to receive the necessary information.[183]

Delegation is also less likely. The feasibility of competing in the global market with a smaller, leaner organization permits boards to be in greater contact with the corporation which they control. Where the corporation of the 1960s competed with facilities in Pittsburgh, Wilmington, and Trenton, the development of IT and flexible manufacturing[184] enable the modern corporation to compete with only one

---

[179] *Id.*

[180] *Id.*

[181] It is suggested that the former is only available in perhaps the smallest of corporations. However, one can imagine a continuum where complete control exists at one end and complete delegation at the other end. Where the corporation falls on this continuum will depend on several factors, the most significant of which is its size. However, the developments which will be discussed at length will also impact when and where the board must delegate responsibility. *See infra* notes 182-92 and accompanying text.

[182] It is sometimes difficult to separate the functions of delegation and reliance. Where delegation is discussed, the reader may presume that reliance is to be included in the discussion and vice versa.

[183] *See* Barnett et al., *supra* note 152, at 9 (discussing minimizing directors' liability for securities fraud). The Roundtable agreed that the proper structure was in place, but the board missed the key issues. *Id.* It was suggested that senior management bore the responsibility for making sure information was received by the board. *Id. See also* Veasey & Seitz, *supra* note 37, at 1503-04 (stating modern perception of role of board may require that compliance program be installed).

[184] Flexible manufacturing permits companies to make numerous products from a single assembly line. Johnson, *supra* note 133, at 48. Johnson explains that

> if auto assembly operations are most efficient at 200,000 cars a year, modern technology permits a manufacturer with only one plant to turn out, say, five distinct models of 40,000 cars each and compete effectively with a manufacturer with five plants, each of which produces 200,000 cars of only

plant in Pittsburgh. Downsizing reduces the number of corporate functions which require delegation.[185]

In addition, integration of firm functions is likely to diminish the horizontal structure which dominated corporate management in the middle part of this century.[186] As noted previously, the business world claims that the most important function of the board is to monitor the CEO.[187] It is suggested that the emphasis on the CEO is driven in part by the fact that, previously, it was not feasible for the board to "know personally all the company's employees."[188] A board could only focus its attention at the top; whereas, a smaller, leaner corporation may permit more familiarity with the company and its personnel and thereby reduce the need for delegation and reliance.[189]

IT also suggests delegation and reliance may be less likely. One can certainly envision a futuristic boardroom where the directors watch as the government of Brazil announces that it will no longer be extending favorable tax credits to the company's subsidiary in Rio de Janiero, and in the next instant be "in close touch with [management's] ideas and reactions [and] views of the [decision]."[190] The future board will have access to "any information, at any time, and any way [they] want to look at it."[191] The directors will be able to form their own independent analyses of the information they received and rely less on management to analyze it for them.[192]

---

one model.

Id.

[185]The impact on reliance is equally obvious. If the directors are more familiar with the persons under their control, they will have a better opportunity to evaluate whether their reliance is reasonable.

[186]*See supra* text accompanying notes 163-70; *see also* text accompanying note 149 (corporations downsizing in order to compete).

[187]*See supra* note 151 and accompanying text.

[188]*Graham*, 188 A.2d at 130.

[189]If the board knows the employees and their functions, then there is no need to appoint someone to report back to the board on what the employees do or how they do it.

[190]MORTON, *supra* note 149, at 12-13.

[191]*Id.* at 13.

[192]This trend is already in place. Outside directors are being encouraged to take a more active role in reviewing the performance of the CEO and the corporation as a whole. *See supra* notes 152-53 and accompanying text. Clifton Wharton Jr., the CEO and chairman of a large institutional investor, would welcome a more independent analysis:

> I believe that the way information is obtained by most corporate boards is one of their greatest weaknesses.
>
> [D]irectors lack *independent* information and analysis regarding a company's performance. Virtually all information comes to the board from management. Its content and use is a potent weapon with which the CEO can

In sum, the immediate and realistic future of corporations suggests that the concepts of delegation and reliance may not be thrown onto the heap of time-worn legislation. However, lawmakers and practitioners should understand that the link between the large, hierarchical organization and the concepts of delegation and reliance may be diminishing. At the minimum, delegation and reliance will take on new meanings, and the areas in which we might traditionally look to find delegation and reliance by the board may shift to different and less predictable places.

2. Defining the Twenty-First Century Standard of Liability

Keeping in mind that the impact of delegation and reliance is changing, this author believes that Dean Manning and Professor Pease established the most realistic test for analyzing a director oversight claim. Under their test, directors violate their duty of oversight when they fail to give sufficient attention to their duties.[193] In this author's opinion, a director gives sufficient attention to his duties if he properly delegates responsibility and reasonably relies on the reports he receives. While that standard does not create a bright line test, it does create a test which incorporates the new meanings which modern developments give to delegation and reliance. In addition, Veasey's and Seitz's belief that *Graham* establishes a red flag test is equally helpful. Certain circumstances, after all, "virtually compel questions."[194]

> influence events. Some CEOs use information to engage the board in sound decision making; others, however, control information so that the bad news is sugar coated or never emerges. Some innundate [sic] directors with financial and production data; others boil down their information so that it loses virtually all substance. The spectrum of practice is wide, but the fundamental weakness is the same: there is no *independent* source of information.

Wharton Jr. et al., *supra* note 150, at 138.

IT, as a source of independent information, has limits, of course. First, IT does not provide a means to assess or predict the intentions of the company's employees. If Fred in sales decides to call a competitor and tell him what price to offer in the market, or if Sue is siphoning funds out of the corporate treasury, the computers sitting in their respective offices will not be able to tell anyone. Someone must take care to properly oversee corporate management. Second, IT may go too far. A board may not want to have *all* of the information. It may want only enough to make an informed decision. In this regard, the board may insist that management trim the fat and deliver the beef, so to speak.

[193]*See supra* text accompanying notes 120-29.

[194]Perkins, *supra* note 72, at 2.

However, if delegation and reliance will continue to limit liability to cases in which the director completely abdicates his function, perhaps the analysis is better carried out under the duty of loyalty. The duty of loyalty exists to prevent individual betterment at the expense of the corporation[195] as well as to promote independent thinking in the boardroom.[196] Both of these factors are present when a director abandons the company. In this situation, the corporation continues to pay the director without receiving any corresponding benefit. Essentially, the director's selfish acts constitute individual approval of the waste of the corporate assets, an act for which courts will impose liability.[197] In addition, a director who makes no decisions at all, or ignores an obvious danger to the company, does not bring an "informed business judgment to bear with specificity upon the corporate merits of the issues."[198] In fact, the director does not bring *any* business judgment to bear at all. Rather, the director succumbs to "extraneous considerations or influences," namely, selfish interests which are placed ahead of those of the corporation.[199] Thus, a case involving director abdication may be easily analyzed under a duty of loyalty.[200]

In addition, using a duty of loyalty test in this context works well with the policy behind Delaware's General Corporation Law. That policy

> has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule . . . requires an undivided and unselfish loyalty to the corporation . . . .[201]

---

[195]*See supra* note 27.

[196]*Id.*

[197]*See Grobow*, 539 A.2d at 189 (noting generally the existence of a claim for waste).

[198]*Aronson*, 473 A.2d at 816.

[199]*Id.*

[200]This article accordingly rejects the negligence analysis employed in *Lutz*. *See supra* text accompanying notes 92-104. Abdicating directors must prove the entire fairness of their actions (or inactions) to the court's satisfaction. *See supra* note 12.

[201]*Guth*, 5 A.2d at 510.

Those words, written more than fifty years ago by the Delaware Supreme Court, are of no less importance today. Recently, the Delaware General Assembly, in the face of an insurance crisis, decided that it would permit Delaware corporations to amend their certificates of incorporation to provide for an express limitation on the liability of their directors.[202] However, the Assembly expressly stated that no amendment to the certificate of incorporation could "eliminate or limit the liability of a director . . . for any breach of the director's duty of loyalty to the corporation or its stockholders."[203] This strong policy of Delaware corporate law reinforces the use of a duty of loyalty test in areas where directors have abdicated their functions.

Admittedly, the use of the duty of loyalty in director oversight cases creates two problems. First, as noted previously, its most useful application is limited to cases where it is obvious that the directors have clearly failed to perform as directors.[204] Second, directors are sure to

---

[202]65 Del. Laws 289 (1986), *codified in* DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). For a discussion of the reason behind the enactment of § 102(b)(7), see *Synopsis*, S. 533, Delaware State Senate, 133d General Assembly, at 2 (1986). Section 102(b)(7) is discussed in greater detail *infra* at notes 209-16 and accompanying text.

[203]DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

[204]The obvious cases are typified by *Lutz*, see *supra* text accompanying notes 92-104, and Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981). In *United Jersey Bank*, the New Jersey Supreme Court found that

> Mrs. Pritchard was not active in the business of Pritchard & Baird and knew virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr., would "take the shirt off my back," Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation.
>
> After her husband died in December 1973, Mrs. Pritchard became incapacitated and was bedridden for a six-month period. She became listless at this time and started to drink heavily. Her physical condition deteriorated, and in 1978 she died.

Id. at 819-20 (citation omitted). To use a baseball analogy, *United Jersey Bank* represents a fat curve ball which courts can easily smack over the fence into the parking lot of liability. The problem with using the duty of loyalty test is that courts are not often handed such softballs. The facts are usually a little more difficult. For example, in Rabkin v. Phillip A. Hunt Chem. Corp., 547 A.2d 963 (Del. Ch. 1986), the former minority shareholders challenged the directors' decision to approve a cash-out merger with Hunt's majority shareholder, Olin Corporation, at $20 per share. *Id.* at 964. Specifically, the plaintiffs alleged that the directors failed to learn of a stock purchase agreement between Olin and a third party in which Olin purchased the third party's majority holdings in Hunt for $25 per share. *Id.* at 965. The agreement required that Olin offer $25 per share if Olin acquired Hunt's remaining shares

resist any attempt to judge their behavior under a duty of loyalty formulation. As noted previously, section 102(b)(7) of the Delaware General Corporation Law permits corporations to insulate their board members from liability for breaches of the duty of care, but not for breaches of the duty of loyalty.[205]

However, applying the duty of loyalty test in director oversight cases also solves two problems. First, it uses familiar terms and standards. In contrast, the use of a negligence or gross negligence test in the oversight context injects an unfamiliar term into corporation law: causation.[206] Ordinarily, one does not speak of causation in corporate law, even under the duty of care.[207] Second, the use of familiar standards would add a degree of certainty in an obviously undefined area of the law.[208] The tests of loyalty and entire fairness have been well-developed.

In summary, in evaluating a director oversight claim, the analysis should not be one of gross negligence. Rather, the analysis should be under the duty of attention. Courts should ask whether the directors have properly delegated duties to management, reasonably relied on information placed before them, and inquired of the board, management, or others when the circumstances so required. In ascertaining whether a board has acted properly, courts should be aware that the concepts of delegation and reliance, to the extent they have not done so already, may become less important in the future.

Director abdication claims require an analysis separate from the duty of attention. Here, such claims may be properly characterized as a violation of the director's duty of loyalty. The duty of loyalty analysis is easily applied and consistent with state corporate law policy.

With new fuel added to the debate over the proper standards in the oversight context, the article could easily end here. However, the development of section 102(b)(7) as an effective defensive weapon compels further discussion. Part III of this article analyzes the

---

within one year of its purchase of Hunt shares. *Id.* On reargument, the court held that the plaintiffs stated a claim against the directors for failing to learn of this agreement. Rabkin v. Phillip A. Hunt Chem. Corp., No. 7547, slip op. at 1-2 (Del. Ch. Dec. 17, 1987), *reprinted in* 13 DEL. J. CORP. L. 1210, 1214 (1988).

[205]DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). For a discussion of § 102(b)(7) and its impact on director oversight liability, see *infra* notes 224-45 and accompanying text.

[206]*See Cede*, 634 A.2d at 367 (rejecting proximate cause and damages as elements of business judgment rule). The inquiries under the duty of care in the decision-making arena are whether the corporation received adequate consideration in a challenged transaction, and whether the directors are informed. *See supra* notes 35-63 and accompanying text.

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

[208]*See supra* text accompanying note 73.

application of section 102(b)(7) in the director oversight and abdication contexts.

III. PART TWO: LEGISLATIVE CONTROLS ON LIABILITY: SECTION 102(b)(7)

A. *Development and Current Statutory Language*

Most commentators attribute enactment of section 102(b)(7) to the Delaware Supreme Court's decision in *Smith v. Van Gorkom.*[209] There is no direct evidence in the legislative history to support such a contention.[210] Rather, the General Assembly seemed concerned that director and officer insurance was becoming unavailable and, as a result, the best directors would not serve on the boards of Delaware corporations.[211] According to the General Assembly, section 102(b)(7) and the other amendments[212] of Delaware law were "intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances."[213] With respect to section 102(b)(7) alone, the Assembly stated that it was intended to allow corporations to "eliminate or limit personal liability of . . . directors . . . for violations of a director's

---

[209]488 A.2d 858 (Del. 1985). *See, e.g.*, Schipani, *supra* note 143, at 20-21.

[210]This article has not examined the director and officer insurance market in the 1980s. However, a reading of the articles which discuss *Van Gorkom* and § 102(b)(7) lends itself to the following analysis. First, the market was probably already in the early stages of an unavailability crisis, as government regulation was on the rise, and government and private lawsuits were around every corner. *See supra* notes 140-48 and accompanying text. RICO was particularly devastating for professionals. *See* McDemus, *supra* note 144, at 1029. *Van Gorkom* was decided in 1985, in the midst of the litigation onslaught. Importantly, *Van Gorkom* did not announce new law. *See* William T. Quillen, Trans Union, *Business Judgment and Neutral Principles*, 10 DEL. J. CORP. L. 465, 466-80 (1985). However, because many shared the view that the *Van Gorkom* case was "one of the worst decisions in the history of corporate law," Daniel R. Fischel, *The Business Judgement Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985), the industry reacted violently and the legislature was forced to act to prevent director flight from Delaware corporations. Interestingly, the legislature took 18 months after *Van Gorkom* to put § 102(b)(7) into effect, suggesting that the problem required deeper study than just the *Van Gorkom* case itself.

[211]*Synopsis*, S. 533, Delaware State Senate, 133d General Assembly, at 2 (1986).

[212]Section 145 of the Delaware General Corporation Law was amended to give the corporation power to indemnify its directors and officers. DEL. CODE ANN. tit. 8, § 145(a) (1992). The amendments also give the corporation power to purchase insurance on behalf of its officers and directors. *Id.* § 145(g).

[213]*Synopsis*, S. 533, Delaware State Senate, 133d General Assembly, at 2 (1986).

fiduciary duty of care."[214] To achieve this stated purpose, the Assembly passed Senate Bill 533 on June 18, 1986, and thereby added subsection 7 to section 102(b).[215] Section 102(b)(7) was recently amended and currently reads as follows:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section the certificate of incorporation may also contain any or all of the following matters:
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) [f]or any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this title [which relates to improper dividends]; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with subsection (a) of § 141 of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.[216]

Delaware courts have had several opportunities to consider section 102(b)(7). These cases are briefly discussed below.

---

[214] *Commentary on Section 102(b)(7)*, S. 533, Delaware State Senate, 133d General Assembly, at 2 (1986).

[215] 65 Del. Laws 289 (1986).

[216] DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). The amended section begins with "and (y) to such other person." 69 Del. Laws 61 (1993).

B. *Recent Application*

1. In General

Most recently, the Delaware Supreme Court considered section 102(b)(7) in *Zirn v. VLI Corp.*[217] In *Zirn*, plaintiff, a shareholder of VLI Corporation (VLI), complained that the directors of VLI and its merger partner failed to disclose the effect of the stock market crash on the reduction in the negotiated merger price.[218] VLI defended the claim on the ground that its certificate of incorporation shielded the directors from liability.[219] The supreme court dismissed the defendants' contention succinctly, noting that section 102(b)(7) did not preclude liability for equitable fraud.[220] The court also noted that the facts implicated the duty of disclosure, a duty which arises under the duty of loyalty, and that section 102(b)(7) did not allow corporations to shield their directors from liability for violations of the duty of loyalty.[221]

The court of chancery, however, has been called on more often than the supreme court to dismiss claims under section 102(b)(7). Where the plaintiff's claim is clearly under the duty of care, the court of chancery has not hesitated to dismiss the claim.[222] However, when the

---

[217]621 A.2d 773 (Del. 1993).

[218]*Id.* at 777. Plaintiff appealed from the court of chancery, which held that the disclosures met the materiality standard. *Id.* The supreme court reversed and remanded the decision on the ground that the vice chancellor misapplied the materiality test. *Id.* at 779. On remand, the court of chancery was instructed to consider the materiality of the information from the perspective of the reasonable shareholder, not from the perspective of the directors. *Id.* at 779-80.

[219]*Id.* at 783.

[220]*Id.*

[221]*Zirn*, 621 A.2d at 783.

[222]*See In re* Wheelabrator Technologies, Inc. Shareholders Litig., No. 11,495, 1992 Del. Ch. LEXIS 196, at *32-41 (Del. Ch. Sept. 1, 1992), *reprinted in* 18 DEL. J. CORP. L. 778, 798-802 (1993) (dismissing claim that directors breached their duty of care by failing to conduct meaningful merger negotiations); Rothenberg v. Santa Fe Pac. Corp., No. 11,749, 1992 Del. Ch. LEXIS 106, at *13 (Del. Ch. May 18, 1992), *reprinted in* 18 DEL. J. CORP. L. 743 (1993) (dismissing plaintiff's claim that directors were grossly negligent in issuing additional shares to noteholders without receiving consideration); John Hancock Capital Growth Management, Inc. v. Aris Corp., No. 9920, 1990 Del. Ch. LEXIS 130, at *5-6 (Del. Ch. Aug. 24, 1990), *reprinted in* 18 DEL. J. CORP. L. 1515 (1993) (dismissing plaintiff's claim that the board's failure to repurchase its bonds at a discount constituted gross negligence).

The cases appearing before the court of chancery more often than not raise a § 102(b)(7) claim as an affirmative defense in a motion to dismiss. In these cases, the chancery court has generally held that it may consider the defense, even when it has not been raised. *See In re Wheelabrator*, No. 11,495, 1992 Del. Ch. LEXIS 196, at *38, *reprinted in*

plaintiff's claim does not identify the particular duty breached, or it is otherwise uncertain at the early stages that the defendants are free of fault, the court has declined to dismiss the claim.[223] To date, only two cases have considered a section 102(b)(7) defense in the face of a claim of director oversight. These cases are discussed below.

2. Director Abdication and Oversight Claims

In re Dataproducts Corp. Shareholders Litigation[224] involved the sale of Dataproducts Corporation to a subsidiary of Hitachi Koko Co., Ltd. and Nissei Sangyo, Ltd.[225] The plaintiff class alleged that the

---

18 DEL. J. CORP. L. at 801 (finding that the court may take judicial notice of a certificate of incorporation); *Rothenberg*, No. 11,749, 1992 Del. Ch. LEXIS 106, at *12, *reprinted in* 18 DEL. J. CORP. L. at 752 (finding that the court may consider the affirmative defense under a motion separate from the motion to dismiss under § 12(b)(6)); *Boeing*, No. 11,273, 1992 Del. Ch. LEXIS 84, at *10, *reprinted in* 18 DEL. J. CORP. L. at 234 (finding that the court may convert a motion to dismiss into a motion for summary judgment when it considers matters outside the complaint, such as the certificate of incorporation).

Section 102(b)(7) has raised other new issues for the court of chancery. In Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992), the court held that a director of a Delaware corporation owes a fiduciary duty to a noteholder whenever the company is insolvent. *Id.* at 790. The defense argued that an anomaly would result because the directors could then be liable to creditors, but not shareholders. *Id.* at 789. Chancellor Allen dismissed the defense's contention, arguing that the anomaly would exist whether he held that insolvency meant insolvency in fact or statutory insolvency. *Id.*

[223]*See* Kahn v. Roberts, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,201 (Del. Ch. Feb. 28, 1994). In *Kahn*, the plaintiff complained that the directors violated their duty of care by hastily approving a stock repurchase agreement. *Id.* at 99,410. The court held that the complaint pleaded facts sufficient to excuse demand based on a duty of care violation. *Id.* at 99,411. The court also declined to dismiss the complaint under § 102(b)(7) because it was unclear whether the defendants had acted in bad faith. *Id.* at 99,414. *See also* Emerald Partners v. Berlin, No. 9700, 1993 Del. Ch. LEXIS 273, at *21 (Del. Ch. Dec. 23, 1993), *reprinted in* 19 DEL. J. CORP. L. 1182 (1994) (holding that complaint which pleaded facts sufficient to excuse demand for claim of waste would not be barred by § 102(b)(7) because if such allegations were true, the directors would have acted in bad faith in knowingly approving a wasteful transaction).

The court of chancery was similarly hesitant in Box v. Telephonics Office Technologies, Inc., No. 13,045, 1993 Del. Ch. LEXIS 272 (Del. Ch. Dec. 30, 1993). In that case, the plaintiffs complained that the directors sold off all of the company assets and then kept the return for themselves. *Id.* at *1-2. The vice-chancellor noted that it was "difficult to discern the exact nature of the duty of care violations." *Id.* at *30. The court stated in *dicta* that any claim under the duty of care for damages would be dismissed but the claims which sought equitable relief, or compensatory damages under a duty of loyalty claim would be allowed to stand, even in the face of a § 102(b)(7) defense. *Id.*

[224][1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227 (Del. Ch. Aug. 22, 1991), *reprinted in* 17 DEL. J. CORP. L. 1159 (1992).

[225]*Id.* at 91,139, *reprinted in* 17 DEL. J. CORP. L. at 1159.

directors abdicated the responsibility of merger negotiations to management.[226] The class further alleged that the directors knew that management caused the merger to take place prior to the announcement that Dataproducts' earnings had risen.[227] The class argued that the offer would have been less attractive had they known that earnings would be up because the value of Dataproducts' stock would have risen.[228]

The court of chancery dismissed the claim.[229] The court found that the complaint failed to sufficiently allege director knowledge of, or involvement in, management's conduct.[230] However, the court stated that, regardless of the allegations, Dataproducts' directors were saved from liability by virtue of the company's certificate of incorporation, which precluded liability for acts of gross negligence.[231] Plaintiffs tried to argue that the directors' abdication amounted to bad faith and intentional misconduct.[232] The court disagreed, finding that the facts in the complaint did not even permit the inference that the directors had acted in bad faith.[233] The court then stated, "For that reason, and because the 'director abdication' claim is equally consistent with director gross negligence as with conduct that was intentional or in bad faith, the plaintiffs have failed to establish that their [abdication] claim is not precluded by Article FIFTEENTH of the certificate of incorporation."[234]

Eight months later, the court of chancery decided *Boeing Co. v. Shrontz*.[235] The complaint alleged the existence of five separate wrongs which the directors of Boeing had knowledge of but did nothing to correct.[236] Specifically, the complaint alleged that in 1989, Boeing pled guilty to the receipt of classified documents, forcing the payment of a $5 million fine.[237] Later in 1989, Boeing was investigated by the government and was charged with excessively overstating leasing and

---

[226]*Id.* at 91,181, *reprinted in* 17 DEL. J. CORP. L. at 1166.

[227]*Id.*

[228]*In re Dataproducts Corp. Shareholders Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227, at 91,181, *reprinted in* 17 DEL. J. CORP. L. at 1166.

[229]*Id.* at 91,183, *reprinted in* 17 DEL. J. CORP. L. at 1169.

[230]*Id.* at 91,182, *reprinted in* 17 DEL. J. CORP. L. at 1168-69.

[231]*Id.*

[232]*In re Dataproducts Corp. Shareholders Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227, at 91,183, *reprinted in* 17 DEL. J. CORP. L. at 1169.

[233]*Id.*

[234]*Id.*

[235]No. 11,273, 1992 Del. Ch. LEXIS 84 (Del. Ch. Apr. 20, 1992), *reprinted in* 18 DEL. J. CORP. L. 225 (1993).

[236]*Id.* at *3-5, *reprinted in* 18 DEL. J. CORP. L. at 231.

[237]*Id.* at *3, *reprinted in* 18 DEL. J. CORP. L. at 231.

tenant improvement costs to the government.[238] The remaining allegations of the complaint charged that Boeing had engaged in other overcharging activity and had purposefully underbid the contract to build Air Force One.[239]

The court of chancery dismissed some of the claims as time-barred.[240] The court then turned to the defendants' contention that their certificate of incorporation barred the remainder of plaintiffs' claims.[241] The court deferred ruling on this contention in light of plaintiffs' argument that they needed to discover whether the amendment had been properly approved.[242] However, the court, in *dicta*, noted that the provisions of the amendment "may eliminate personal liability of directors for the types of claims asserted here."[243] Finally, the vice-chancellor addressed the merits of the claims. She determined that plaintiffs' allegation that the "directors knew of unlawful conduct for a long time and did nothing" was, although factually non-specific, sufficient to state a claim.[244] The vice-chancellor cited the second, "gross negligence" standard of *Graham* as the appropriate standard to apply in cases of director neglect.[245]

---

[238] *Id.* at *3-4, *reprinted in* 18 DEL. J. CORP. L. at 231.

[239] *Boeing*, No. 11,273, 1992 Del. Ch. LEXIS 84, at *4-5, *reprinted in* 18 DEL. J. CORP. L. at 231.

[240] *Id.* at *9, *reprinted in* 18 DEL. J. CORP. L. at 233. Demand was made on the board on August 23, 1989 and the complaint was filed on December 8, 1989. *Id.* at *6 n.1, *reprinted in* 18 DEL. J. CORP. L. at 232 n.1. Delaware has a three-year statute of limitations to recover monetary damages. DEL. CODE ANN. tit. 10, § 8106 (1974); *Boeing*, No. 11,273, 1992 Del. Ch. LEXIS 84, at *5, *reprinted in* 18 DEL. J. CORP. L. at 232. The court, finding that the complaint did not plead with particularity that the illegal conduct had been fraudulently concealed, barred all claims which arose prior to August 23, 1986. *Id.* at *8-9, *reprinted in* 18 DEL. J. CORP. L. at 233.

[241] *Boeing*, No. 11,273, 1992 Del. Ch. LEXIS 84, at *9-11, *reprinted in* 18 DEL. J. CORP. L. at 233-34.

[242] *Id.* at *10-11, *reprinted in* 18 DEL. J. CORP. L. at 234.

[243] *Id.* at *10, *reprinted in* 18 DEL. J. CORP. L. at 234.

[244] *Id.* at *14, *reprinted in* 18 DEL. J. CORP. L. at 236. In light of the court's acknowledgement that the directors knowingly permitted their company to engage in wrongdoing, it is rather surprising that the court was willing to excuse their conduct under § 102(b)(7). Clearly, the acts involved a knowing violation of law.

[245] *Id.* *See supra* text accompanying notes 76-77 (discussing the two standards established in *Graham*). In considering this issue previously, Vice-Chancellor Berger noted that a mere negligence standard was appropriate. *Rabkin*, No. 7547, slip op. at 6-7, *reprinted in* 13 DEL. J. CORP. L. at 1216-17.

C. *Analysis and Summary*

These two cases suggest that claims of director oversight will run head-first into the defensive wall permitted by section 102(b)(7). Both courts seemed intent on analyzing director abdication claims under the duty of care or a gross negligence standard. The court in *Dataproducts* even went so far as to prevent the plaintiffs from framing the issue in any terms other than gross negligence. However, the plaintiff's bar need not recoil just yet, for arguably the holdings are mere *dicta*.

As a whole, the Delaware judiciary seems concerned with preventing the elimination of duty of loyalty claims. Counsel who can frame an oversight claim in terms of the duty of loyalty--perhaps using the analysis outlined above--may stand a far better chance of surviving the section 102(b)(7) defense. "[T]he cases do not so hold, but leave room for such an argument."[246]

IV. CONCLUSION

Due to the contradictory standards governing the duty of oversight announced by the Delaware Supreme Court in *Graham v. Allis-Chalmers*, commentators have debated what standard should govern the duty of oversight. Although the Delaware courts have not articulated a clear standard, the courts, in determining whether directors violated their duty of oversight, have traditionally focused on delegation of responsibility and reliance on information.

Government regulation, global competition, and information technology are changing the role of the board of directors and, more specifically, the concepts of delegation and reliance. In this climate of rapid change, a director should not be held to violate his duty of oversight if he properly delegates responsibility and reasonably relies on reports he receives. However, if the typical director defenses of delegation and reliance limit liability to cases in which the director completely abdicates his function, the cases should be evaluated using a duty of loyalty analysis. By framing director oversight claims in terms of the duty of loyalty, plaintiffs' counsel may be able to prevent the use of the section 102(b)(7) defense which has been successful in recent director oversight cases.

---

[246]Veasey & Seitz, *supra* note 37, at 1502.