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THE DUTY OF CARE COMPONENT OF THE DELAWARE BUSINESS JUDGMENT RULE

BY HENRY RIDGELY HORSEY*

I. INTRODUCTION

It is an honor, indeed, to be invited to present the Francis G. Pileggi Lecture at Widener University School of Law—on an aspect of Delaware corporate law which I hope will be of interest to you.

The Widener University School of Law, in a relatively few years, has developed a reputation of significant contribution to the Bar and Bench of Delaware, in particular, in the field of corporation law. Your *Delaware Journal of Corporate Law* is recognized today as one of the outstanding journals of its kind in the country in the field of Delaware corporation law. In part, this stems from the unique relationship that exists between the law school and its adjunct faculty of sitting and retired members of the Delaware judiciary. That relationship has been further strengthened through the establishment of the Wolcott Fellowship program. Through it, your students witness first hand and close-up the operation of the appellate process in Delaware.

My topic is "The Duty of Care Component of the Delaware Business Judgment Rule." This is a subject with which I have a

* Justice, Supreme Court of Delaware (Retired).

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fair degree of familiarity and for which I have received my share of slings and arrows over the past ten of my fifteen years of service, from 1978 to 1994, on the Delaware Supreme Court.

Before proceeding on this subject, let me offer a word of caution about the frequently misunderstood job of judging. Judging—particularly appellate judging—is, to laymen, at least, a unique and mystifying process. Judges are sometimes viewed as some sort of modern day priests, possessing divine powers and with privileged access to deep, dark secrets in the form of legal principles simply waiting to be discovered and propounded.

The reality is that the process of judging is far less mysterious than it is frequently made out to be. Generally, judges seek to apply existing state law and precedent, if available and consistent with contemporary societal norms, to a particular array of facts for the purpose of achieving what seems to be the appropriate and just result. But real life judges cannot measure up to what some legal philosophers have fashioned as the theoretically ideal judge. Ronald Dworkin defined the latter, whom he aptly named "Hercules," as one who masterfully synthesizes all precedent, fact patterns, and public policy issues so as to be assured of reaching the objectively right result in any given case, no matter how hard it is.

In the field of corporate law, a tough corporate case presents a fertile field for disagreement—in terms of a judge's goal of reaching what appears to be the correct result and then defining a means and course for attaining it.

No aspect of Delaware corporation law has been more unsettling to commentators than the Delaware Supreme Court's rulings in the area of the duty of care of a disinterested corporate fiduciary—usually in the context of a sale of a company. Nowhere has this court's decisions sparked such vociferous commentary, and harsh criticism, as in the *Trans Union* case, also known as *Smith v. Van Gorkom*.[1] The most recent decision of the Delaware Supreme Court on this question, *Cede & Co. v. Technicolor*,[2] will presumably also be the subject of critical commentary.

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1. 488 A.2d 858 (Del. 1985). *See, e.g.*, Morton Moskin, Trans Union: *A Nailed Board*, 10 DEL. J. CORP. L. 405 (1985) (finding various faults with the court's opinion and setting forth guidelines to allow a board of directors to prove that its decision was informed); Steven F. Mones, Comment, *Mining the Safe Harbor? The Business Judgment Rule After* Trans Union, 10 DEL. J. CORP. L. 545 (1985) (suggesting the court's opinion in *Trans Union* threatened the safe harbor afforded directors by the business judgment rule).

2. 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

Largely overlooked in the analysis of this area of Delaware corporate law is that these are cases which are determined by their facts, and their holdings are not determined in the abstract. Melding facts to legal principles is the art of judging. It is a difficult art and a contentious one. Such is certainly true of the evolution of the fiduciary duty of care in Delaware. Since I have been privileged to be a member of a court which has been required to confront these issues on appeal in several noteworthy cases over the last ten years, I thought I would share with you my thoughts on this subject: the relation of the duty of care to the application by courts of the business judgment rule to corporate fiduciaries not found to be disloyal or lacking in good faith.

Bear in mind that my comments are my own and are made from the perspective of a former justice of the Delaware Supreme Court. Thus, the usual disclaimers apply. My statements should not be interpreted as reflecting anything other than my personal views which have not been shared with my former colleagues.

II. EVOLUTION OF THE DUTY OF CARE AS A COMMON LAW PRINCIPLE OF CORPORATE LAW

The duty of care of corporate directors has its origins in English common law of both trusts and agency from over 200 years ago. One of the earliest reported English cases on director duty of care, *Charitable Corp. v. Sutton*,[3] decided in 1742, contains what has been characterized as a "remarkably modern formulation" of the duty of care.[4] "By accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence . . . ."[5] The court found the directors of a charitable corporation to have failed to monitor the loan procedures of the corporation in making unsecured loans to fellow directors. Therefore, the directors were held liable for the resulting loan losses because their actions constituted gross negligence.[6]

In this country, by the nineteenth century, the concept that corporate directors owed a common law fiduciary duty of care to

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3. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

4. Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 593 n.7 (1983).

5. *Sutton*, 2 Atk. at 406, 26 Eng. Rep. at 645.

6. *See id.* at 405-06, 26 Eng. Rep. at 644-45.

their institutions was recognized but was generally confined to the directors of banks and financial institutions. State courts in this country defined the duty of care of bank directors by analogizing their duty to trust law standards of care. Bank directors were required to exercise "the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs."[7] These courts reasoned that "[o]ne who voluntarily takes the position of director, and invites confidence in that relation, undertakes, like a mandatary, with those whom he represents or for whom he acts, that he possesses at least ordinary knowledge and skill, and that he will bring them to bear in the discharge of his duties."[8] So spoke a New York state court over a hundred years ago in *Hun v. Cary*.[9] In *Cary*, the New York Court of Appeals found the defendant directors liable for action that was "not a case of mere error or mistake of judgment . . . but . . . a case of improvidence, of reckless, unreasonable extravagance, in which [the defendants] failed in that measure of reasonable prudence, care and skill which the law requires."[10]

By the latter part of the nineteenth century and the beginning of the twentieth century, the concept that corporate directors owed a fiduciary duty of care to their corporations and its stockholders had extended to the directors of industrial corporations. The most frequently cited case in this country near the turn of the century was the United States Supreme Court's decision in *Briggs v. Spaulding*.[11] In *Briggs*, the Supreme Court stated that directors should be held to the action of "ordinarily prudent and diligent men."[12] Thereafter, and following *Briggs*, courts most commonly defined the due care standard of a corporate director in terms of the conduct of a reasonable and prudent person.

By the early part of this century, courts across the country accepted the proposition that officers and directors of industrial concerns, as well as banks, and their majority shareholders stood in a fiduciary relationship to their corporation and to their minority shareholders. Courts recognized that directors, as quasi-trustees, should be judged by fiduciary standards of not simply good faith but prudent conduct.

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7. Hun v. Cary, 82 N.Y. 65, 71 (1880).
8. *Id.* at 74.
9. *Id.*
10. *Id.* at 78-79.
11. 141 U.S. 132 (1891).
12. *Id.* at 152.

Concurrent with the development of the concept of a director's duty of care, courts recognized the need for judicial restraint against imposing liability on corporate fiduciaries for mere errors of judgment. Here, too, the concept of limiting the liability of directors by exonerating them for judgmental error had its origins in English common law as old as the common law duty of care. The English 1742 case earlier referred to, *Charitable Corp. v. Sutton*,[13] may also be the "father" of what is commonly referred to today in this country as the so-called "business judgment rule."

In this country, the rule of judicial deference for judgmental error of directors finds expression as early as 1829 by a state court in Louisiana.[14] In 1850, a Rhode Island state court expressed similar judicial concern for exonerating directors for judgmental error in *Hodges v. New England Screw Co.*[15] In exonerating directors from liability for having violated a charter provision against investing the company's assets in the stock of another corporation, the *Hodges* court concluded that the mistake was an innocent one and one which the court presumably found the directors had made while exercising due care. Note the court's language: "If . . . the mistake be such as the directors might well make, notwithstanding the exercise of proper care, and if they acted in good faith and for the benefit of the [corporation], they ought not to be liable."[16]

One of the most comprehensive and balanced articulations of a corporate director's fiduciary duty of care and loyalty, in the context of the operation of the business judgment rule, is found in a decision issued in 1940 by the New York Supreme Court in *Litwin v. Allen*.[17] I quote from Justice Shientag in *Litwin*:

> It is clear that a director owes loyalty and allegiance to the company—a loyalty that is undivided and an alle-

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13. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

14. *See* Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829) (holding that directors of a bank are only responsible for errors "of so gross a kind, that a man of common sense, and ordinary attention, would not have fallen into it").

15. 1 R.I. 312 (1850), *reh'g granted*, 3 R.I. 9 (1853).

16. *Id.* at 346, *cited in* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 6-7 n.23 (4th ed. 1993).

17. 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940). Justice Shientag's decision promptly received prominent recognition in many of the law schools of this country. I might add that, Ralph Baker, along with Merritt Dodd, were professors of corporation law at Harvard Law School in 1950-1952 and were the authors of the corporate textbook I used at Harvard. A perusal of the pages of that textbook shows that over forty years ago the duty of care received almost equal textbook treatment with duty of loyalty and, as I recall, nearly equal treatment in classroom discussions.

> giance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation and in conflict with its rights; he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment. In the discharge of his duties a director must, of course, act honestly and in good faith, but that is not enough. He must also exercise some degree of skill and prudence and diligence.
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> . . . [D]irectors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence . . . . In the last analysis, whether or not a director has discharged his duty, whether or not he has been negligent [i.e., violated the duty of care], depends upon the facts and circumstances of a particular case, the kind of corporation involved, its size and financial resources, the magnitude of the transaction, and the immediacy of the problem presented. A director is called upon "to bestow the care and skill" which the situation demands.
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> . . . But clairvoyance is not required even of a bank director. The law recognizes that the most conservative director is not infallible, and that he will make mistakes, but if he uses that degree of care ordinarily exercised by prudent bankers he will be absolved from liability although his opinion may turn out to have been mistaken and his judgment faulty.[18]

It seems quite clear under Justice Shientag's formulation of the business judgment rule that for the rule of judicial deference to be invoked, directors of a board must be found to have met not only their duty of loyalty but also their duty of care.

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18. *Litwin*, 25 N.Y.S.2d at 677-78 (citation omitted) (quoting New York Cent. R.R. v. Lockwood, 84 U.S. 627 (1873)).

III. APPLICATION OF THE BUSINESS JUDGMENT RULE IN THE CONTEXT OF A DIRECTOR'S DUTY OF CARE

Before proceeding to the Delaware case law in this field, I review briefly the manner in which other courts in this country have applied the rule of judicial deference to corporate management in the context of claims of breach of fiduciary duty. The subject has, as one might imagine, been addressed at least several times by commentators more astute than I. So let me first summarize some of their findings, focusing primarily on breach of duty of care claims.

Those who surveyed the duty of care case law in this country before the mid-eighties found an infertile field and were in nearly unanimous agreement as to their findings: the business judgment rule had been applied in such a manner as to constitute an almost per se bar to shareholder claims of directors' breach of their fiduciary duty of care.[19]

In 1981, George W. Dent, Jr., then a professor at Cardozo School of Law, wrote: "When stated in the abstract, the duty of care seems to impose a meaningful obligation on directors and officers. In practice, however, the duty has had almost no effect on corporate governance for several reasons, not the least of which is confusion over the proper functions of directors."[20] Dent states that, while the ideal of a common law duty of care of corporate fiduciaries is fairly straightforward and was later embodied in many state statutes, the duty of care by 1980 had become, in his words, "moribund."[21] The duty of care was, in effect, subsumed within the business judgment presumption accorded to director action carried out in good faith, absent evidence of disloyalty. Dent attributes the

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19. *See, e.g.*, Cohn, *supra* note 4, at 594.

20. George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U. LAW REV. 623, 644-45 (1981). In his article, Dent discusses the role of a "revived" duty of care in ensuring that directors play a "monitoring role" in an era where this governance model has "gained wide acceptance." *Id.* at 623. The monitoring model requires, at least, that the board "select[ ], evaluat[e], and, if necessary, remov[e] and replace directors and corporate executives. Corollary functions include fixing management's compensation, reviewing transactions between the corporation and its insiders, and overseeing management's compliance with the law." *Id.* at 630 (footnote omitted). The debate on corporate governance reform continues today. *See, e.g.*, The New Dynamics of Corporate Governance; Guidance for the 1990's, Dec. 2-3, 1993 (comments of Martin Lipton at the American Bar Association Conference) (quoting Chancellor Allen's description of outside directors as continual active monitors of management and describing specific board reform proposals).

21. Dent, *supra* note 20, at 646.

decline in judicial enforcement of director duty of care to a misunderstanding of the underlying precepts of the business judgment rule. In his *Boston University Law Review* article, Dent states:

> The "business judgment" rule is incontestable if it is recognized that to invoke the rule the director must exercise his judgment within the scope of the duty of care—that is, his judgment must have been reasonable and exercised with the care of an ordinarily prudent person. However, courts have often described the business judgment rule without any reference to the duty of care and, more important, have often dismissed suits against directors on the ground of the business judgment rule without first inquiring whether the directors had acted reasonably and with due diligence. *In some cases, courts have simply ignored a statutory "prudent man" standard in favor of a fraud or bad faith standard under the business judgment rule.* Moreover, courts have frequently extended the rule beyond its original purpose; for example, it has been used to prevent shareholder interference with directors' decisions even though the shareholder did not seek to hold the directors liable for their actions.[22]

Dent was not the first law review commentator to attribute judicial confusion in defining the fiduciary duty of care of a director to a misunderstanding of the formulation and operation of the business judgment rule. Two years earlier, in 1979, S. Samuel Arsht, a distinguished member of the Delaware Bar and lawyer of national repute in the field of corporation law, wrote an article which argued that the rule was generally misunderstood as well as inaccurately, if not erroneously, applied by courts generally, and in particular, by the Delaware courts.[23] Arsht offered a constructive proposal by way of proposed restatement of the elements and operation of the business judgment rule, which I will return to later.[24]

Commentators who surveyed duty of care decisional law through the 1970s identified only a handful of cases outside the context of financial institutions in which directors of business corporations had been found liable for breach of their duty of care. In one survey,

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22. *Id.* at 647 (footnotes omitted) (emphasis added).

23. S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

24. *Id.* at 111-12. *See infra* text accompanying note 120.

Joseph W. Bishop, a professor at Yale Law School, found only four cases of derivative litigation in which disinterested directors had been found to have breached their fiduciary duty of care.[25] Bishop stated that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence[,] uncomplicated by self-dealing[,] is a search for a very small number of needles in a very large haystack."[26] Of the four cases holding directors to have breached their duty of care, Bishop opined that "none of these cases [carry any] real conviction."[27]

Fifteen years later, in 1983, Stuart R. Cohn, professor of law at University of Florida, reached the same conclusion.[28] Cohn, after a similar study of case law involving claims of director breach of duty of care in the absence of self-interest or self-dealing, found what he characterized as "a nearly universal judicial reluctance to apply diligence standards against well-intentioned, non-self-enriching directors and officers."[29] Cohn stated:

> Courts often commence[d] their opinions with the stern but tired maxims of fiduciary duties, or the common-law and statutory norms of diligence and care, only to subsequently invoke the purifying balm of the "business judgment rule" . . . to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality.[30]

Cohn, like Bishop, attributed this result to a number of factors, and, in particular, to what he characterized as "judicial concern" over the ambiguity of due care standards and the severity of available sanctions, particularly when imposed upon directors who "are often far removed from the epicenter of information and actual decision-making."[31] Cohn lamented what he considered a misuse of the current state of the business judgment rule by courts generally, by titling his 1983 article, "Demise of the Director's Duty of Care: Judicial

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25. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968).
26. *Id.*
27. *Id.* at 1100.
28. Cohn, *supra* note 4, at 593-94.
29. *Id.* at 593.
30. *Id.* at 593-94.
31. *Id.* at 598-99.

Avoidance of Standards and Sanctions Through the Business Judgment Rule."[32]

Fletcher, in his multi-volume treatise on corporation law, similarly summarized the state of the law in the mid-seventies on the operation of the business judgment rule.[33] He stated: "Because [directors] are given [a] wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the head of honest mistakes."[34] As Fletcher baldly put it, "even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs," the business judgment rule will be applied.[35]

More recently, Krishnan Chittur, a Harvard Law School doctoral candidate, published another review of the state of the law on director duty of care.[36] Chittur concluded, as had Bishop, Cohn, and Dent, that the business judgment rule has historically proved to be "a very potent defense for corporate directors and officers against claims primarily asserted by shareholders for loss resulting from decisions that went awry."[37] Chittur argued for the principles stated in *Casey v. Woodruff*,[38] later echoed by Arsht in 1979,[39] and ultimately adopted by the Delaware Supreme Court in 1984 in *Aronson v. Lewis*.[40] Chittur states: "When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised."[41] Yet Chittur concluded that "[w]hile rhetoric abounds regarding the standard of care to be met before this [business judgment] protection may be claimed, rarely have individual directors been held liable."[42]

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32. Cohn, *supra* note 4, at 591.

33. 3A WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (rev. perm. ed. 1975).

34. *Id.*

35. *Id.*

36. Krishnan Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505 (1985).

37. *Id.* at 507.

38. 49 N.Y.S.2d 625 (N.Y. Sup. Ct. 1944).

39. Arsht, *supra* note 23, at 119.

40. 473 A.2d 805 (Del. 1984).

41. Chittur, *supra* note 36, at 505 n.2 (quoting *Casey*, 49 N.Y.S.2d at 643).

42. *Id.* at 505 (footnote omitted).

IV. DUTY OF CARE AND THE BUSINESS JUDGMENT RULE IN DELAWARE

I now turn to Delaware decisional law as it relates to a director's fiduciary duty of care in the context of the formulation and operation of the Delaware business judgment rule. The story is both interesting, and perhaps, surprising. Given the degree of sophistication and reputation attained by the Delaware courts in their unparalleled development of a body of corporate decisional law in the first half of the century, one would expect to find over that period of time an "evolutionary" development of Delaware law defining the fiduciary duties of directors for judicial deference to be accorded director judgment. Evolution, of course, connotes that the current state of a subject is the end result of a construction process that has proceeded in a logical and predictable manner over time. With that assumption, I asked my clerks to "flag" every Delaware corporate law decision in this century that contained any discussion of a director's fiduciary "duty of care," "due care," or simply, "care." I also asked them to make the same search for Delaware case law usage of the terms "business judgment" or "business judgment rule."

My findings on this aspect of Delaware corporate decisional law were as disappointing as that earlier encountered by Bishop in his national search for cases in which courts' found directors to have failed in their fiduciary duty of care. What one would expect to find would be a more well-developed explication of a corporate director's fiduciary duty of care as well as loyalty and a more articulate consideration of their relationship to the operation of the business judgment rule.

Perhaps the earliest statement by a Delaware court of fiduciary conduct expected of corporate directors is found in *Bodell v. General Gas & Electric Corp.*[43] In *Bodell*, the Delaware Court of Chancery invoked equitable principles in placing limits upon directors' exercise of their statutory authority (statute governing the issuance of no-par stock). Chancellor Wolcott stated that "[w]hile [directors] are not trustees in the strict sense of the term, yet for convenience they have often been described as such. With respect to the unissued stock,

43. 132 A. 442 (Del. Ch. 1926), *aff'd*, 140 A.2d 264 (Del. 1927).

they are said to control it as trustees."[44] The court went as far as to say,

> It is not always necessary for [the directors] to reap a personal profit or gain a personal advantage in order for their actions in performance of their quasi trust to be successfully questioned. Trustees owe not alone the duty to refrain from profiting themselves at the expense of their beneficiaries. They owe the duty of saving their beneficiaries from loss.[45]

Until 1963, Delaware courts frequently spoke to the subject of fraud, actual or constructive, but seldom, if ever, and only in oblique terms, to a director's fiduciary duty to act in an informed manner and with the care that a reasonable and prudent person would exercise under similar circumstances.[46] Our search of Delaware case law through the first half of this century simply confirmed Professor Bishop's findings nearly thirty years ago.

Through the 1950s, there was surprisingly little Delaware decisional law articulating, in any more comprehensive manner than in *Bodell*, the Delaware business judgment rule. One will find no definition of the components and operation of the Delaware rule that approaches the degree of sophistication articulated in 1940 by the New York Supreme Court in *Litwin v. Allen*.[47] In sum, no Delaware court decision espouses the existence of a director's fiduciary duty to act in an informed manner and with the care of a prudent man

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44. *Id.* at 446.

45. *Id.* at 447. For similar statements, see also Karasik v. Pacific E. Corp., 180 A. 604, 607 (Del. Ch. 1935) ("[T]here is a presumption, rebuttable of course, that the directors of a corporation are actuated in their conduct of the business of the corporation by a bona fide regard for the interests of the corporation."); Davis v. Louisville Gas & Elec. Co., 142 A. 654, 660 (Del. Ch. 1928) (stating that the court will not interfere in the judgment of directors unless sufficient facts exist which indicate that the directors failed to act in good faith); and Robinson v. Pittsburgh Oil Ref. Corp., 126 A. 46 (Del. Ch. 1924).

46. *Compare Robinson*, 126 A. at 48 (stating that directors are "clothed with [the] presumption [that] their conduct [was activated by] a bona fide regard for the interests of the corporation . . . ." The terms and conditions of the board of directors' sale of the company to be overturned must be found to be "so manifestly unfair as to indicate fraud and thereby overcome the presumption of fairness which otherwise would prevail in their favor.") *with* Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933) (stating that a sale of corporate assets will not be set aside unless a minority shareholder can establish an inadequacy of price "so gross as to display itself as a badge of fraud.").

47. *See supra* text accompanying note 18.

until the decision of our separately constituted supreme court in 1963 in *Graham v. Allis-Chalmers Manufacturing Co.*.[48]

The earliest Delaware case, and arguably the first decision of a Delaware court to attempt an articulation of a director's standard of care, is Chancellor Wolcott's famous and oft-cited decision in *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*.[49] There, the court granted a preliminary injunction against the sale of the company based on a minority shareholder's claim of fraud and inadequate price and in the absence of any finding of substantial director self-interest or self-dealing. The court, while recognizing the majority shareholders' statutory authority to sell the corporation's assets, ruled that even in the absence of a badge of fraud, majority shareholders have a duty to obtain a fair price and may not exercise a "reckless indifference" in selling the assets of the company.[50] I quote the court's precise language:

> It is further true that inadequacy of price will not suffice to condemn the transaction as fraudulent, unless the inadequacy is so gross as to display itself as a badge of fraud. I take it that so long as the inadequacy of price may reasonably be referred to an honest exercise of sound judgment, it cannot be denominated as fraudulent. When the price proposed to be accepted is so far below what is found to be a fair one that it can be explained only on the theory of fraud, or a reckless indifference to the rights of others interested, it would seem that it should not be allowed to stand.[51]

The fact that Clarence Dillon, of Dillon, Reed & Co., headed up the syndicate that purchased a majority interest in the company before it contracted to sell its assets to a third party caused the court to be suspicious that the price was not fair.[52]

Building on the *Bodell* decision of 1926, *Cole v. National Cash Credit Ass'n*,[53] represents perhaps the earliest recognition by a Delaware court that grossly imprudent conduct of otherwise disinterested directors will not receive exoneration under the business judgment

48. 188 A.2d 125 (Del. 1963).
49. 120 A. 486 (Del. Ch. 1923).
50. *Id.* at 494.
51. *Id.*
52. *Id.* at 496.
53. 156 A. 183 (Del. Ch. 1931).

rule. The shareholder claim stated in *Cole* was based on an alleged undervaluation of the assets of the company and an overvaluation of the assets of the so-called "merger partner."[54] Finding little Delaware law precisely on point, Chancellor Wolcott found in Indiana law an apt standard: "When the fraud charged is of this nature, it must be so plainly made out as to disclose a breach of trust or such mal-administration as works a manifest wrong to the dissentients."[55] Wolcott then stated, "The overvaluation or undervaluation[,] as the case may be[,] must be such as to show a conscious abuse of discretion before fraud in law can be made out."[56] In finding the shareholder's proof insufficient to meet this test, the Chancellor did not simply rely upon his decision in *Allied*, but New Jersey law as well, as stated in *Donald v. American Smelting & Refining Co.*[57] Drawing on his earlier language in *Allied*, as well as the Indiana and New Jersey case precedents, Chancellor Wolcott in *Cole* formulated the following rule for finding an actionable breach of trust in the absence of actual fraud or disloyalty of directors: "[M]ere inadequacy of price will not reveal fraud. The inadequacy must be so gross as to lead the court to conclude that it was due not to an honest error of judgment *but rather to bad faith, or to a reckless indifference to the rights of others interested.*"[58] The court in *Cole* then articulated what it considered the elemental requirements for invoking the Delaware business judgment rule—good faith and a "*bona fides*" purpose.[59] Wolcott stated: "There is a presumption that the judgment of the governing body of a corporation . . . is formed in good faith and inspired by a bona fides of purpose."[60] The court relied on Thompson, a noted textwriter of the time, for the underlying premise of the rule:

> "Courts of equity," says Mr. Thompson in his Works on Corporations, § 4518, "cannot be called upon to control the discretion of the managing bodies of corporations; otherwise, they would be choked with applications of recalcitrant stockholders. The action of a board of directors may be ill-advised or apparently unprofitable, but this furnishes

54. *Id.* at 187.
55. *Id.* (citing Raff v. Darrow, 111 N.E. 189 (Ind. 1916)).
56. *Id.*
57. 48 A. 786, 788 (N.J. Ch. 1901), *rev'd*, 48 A. 771 (N.J. 1901).
58. *Cole*, 156 A. at 188 (emphasis added).
59. *Id.*
60. *Id.* (citing Davis v. Louisville Gas & Elec. Co., 142 A. 654 (Del. Ch. 1928); Robinson v. Pittsburgh Oil Ref. Corp., 126 A. 46 (Del. Ch. 1924)).

no ground for invoking the restraining powers of the court."[61]

Wolcott's formulation in *Bodell* and *Cole* of the judicial deference accorded a defendant board would remain until, the early 1970s, the definitive and oft-repeated statement of Delaware courts in shareholder derivative suit claims against Delaware corporate fiduciaries.[62]

In 1943, the court of chancery, in *Porges v. Vadsco Sales Corp.*,[63] again applied *Cole*'s standard of reckless indifference to the rights of others in reviewing the conduct of directors not found to be disloyal.[64] Vice-Chancellor G. Burton Pearson, Jr. denied a preferred shareholder's request to enjoin a merger after finding that the shareholder's evidence was insufficient to overcome the Delaware courts' preemptive view of the business judgment rule, i.e., the "presumption that the judgment of the governing body [was] formed in good faith and inspired by a bona fides of purpose."[65]

In 1957, the Delaware Supreme Court, in *Cottrell v. Pawcatuck Co.*,[66] deferred to the business judgment of the directors in a sale of corporate assets, noting that the sale "proceeded in an orderly manner, without undue haste, and resulted in an arm's-length bargain."[67]

Only a creative reading of Delaware decisional law through the 1950s, and usually through dicta, would arguably support a thesis that a director of a Delaware business corporation, as a fiduciary, should be held to a duty to act with care in the manner a reasonable and prudent person would act under similar circumstances.[68]

Not until 1963, in *Graham v. Allis-Chalmers*,[69] did a Delaware court first recognize the existence of a director's fiduciary duty to act in an informed and prudent manner, i.e., with due care, for the rule to be invoked. The case involved a derivative action against a company's directors, which grew out of antitrust indictments, to

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61. *Id.* (citing *Donald*, 48 A.2d at 788).

62. *See* ERNEST L. FOLK, III, THE DELAWARE GENERAL CORPORATION LAW; A COMMENTARY AND ANALYSIS § 144, at 75-76 (1972).

63. 32 A.2d 148 (Del. Ch. 1943).

64. *Id.* at 151.

65. *Id.* at 151-52.

66. 128 A.2d 225 (Del. 1957), *cert. denied and appeal dismissed*, 355 U.S. 12 (1957).

67. *Id.* at 229.

68. One possible explanation for the Delaware judiciary's late recognition of a business director's fiduciary duty of care may be simply the failure of shareholder plaintiffs to assert a claim of failure to act as a prudent man would be expected to act.

69. 188 A.2d 125 (Del. 1963).

which the directors and Allis-Chalmers had pled guilty.[70] The suit sought to recover damages which the company allegedly suffered as a result of the criminal violations.[71] Plaintiffs charged the director defendants with actual knowledge of the company's antitrust conduct and alternatively with knowledge of facts which should have put the director defendants on notice of their unlawful conduct.[72] When plaintiffs found they could not prove that any director had actual knowledge of the antitrust activity, or of the facts underlying it, plaintiffs alternatively asserted that the directors were nevertheless liable, as a matter of law, for failure to take reasonable steps to discover the existence of such unlawful conduct.[73] Plaintiffs argued that this was particularly so in light of the company's having entered into a consent decree to desist from similar conduct in 1937.[74]

The importance of *Graham* lies not in the ultimate holding, but in the fact that not until 1963 did the Delaware Supreme Court recognize the substantial body of decisional law holding a corporate director to a fiduciary duty of care. I refer to the United States Supreme Court's 1891 decision in *Briggs v. Spaulding*, previously discussed, and several federal court of appeals decisions, including a twenty-four-year-old decision, *Atherton v. Anderson*.[75] Unable to distinguish those decisions, Justice (and former Chancellor) Daniel F. Wolcott, speaking for the court in *Graham*, made the following statement:

> *[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. Their duties are those of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts . . . .[76]

This statement of the Delaware Supreme Court, acknowledging that directors who seek the protection of the business judgment rule will be held to a duty of care as well as a duty of good faith and loyalty,

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70. *Id.* at 127.
71. *Id.*
72. *Id.*
73. *Graham*, 188 A.2d at 127.
74. *Id.* at 129.
75. 99 F.2d 883 (6th Cir. 1938).
76. *Id.* at 130 (emphasis added).

is believed to represent the first explicit recognition by a Delaware court of such a duty.[77]

The court in *Graham* then proceeded to resolve, on the facts, the question adversely to the plaintiffs. The court stated:

> In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.[78]

In this manner, the court found that no director had breached his duty of care for arguably failing to put in place at Allis-Chalmers a monitoring system to detect illegal activities within the company.[79]

While *Graham*'s relevance has been muted by the Delaware Supreme Court's subsequent interpretations of the case as not "ac-

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77. The Delaware cases before 1963 containing any mention of holding a corporate fiduciary to a prudent man standard were usually confined to shareholder suits asserting claims of corporate waste. *See* Saxe v. Brady, 184 A.2d 602, 610 (Del. 1962) (holding that where a waste of corporate assets has been alleged, the court must examine the facts of the situation; however, its examination is restricted to determining if "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid"); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58-59 (Del. 1952) (stating that the court will not find waste if appraisal of value received by the corporation "brings the court within the realm in which reasonable men, fully informed and acting in good faith, may be expected to differ"); Kaufman v. Shoenberg, 91 A.2d 786, 791 (Del. Ch. 1952) ("Where there has been independent stockholder ratification of interested director action, the objecting stockholder has the burden of showing that no person of ordinary sound business judgment would say that the consideration received . . . was a fair exchange . . . .").

78. *Graham*, 188 A.2d at 130.

79. *Id.* at 130-31. *Graham* was criticized by William Cary in his seminal article attacking Delaware law. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 683-84 (1974). Cary suggests that "a state less hospitable [to managerial interests] than Delaware might have imposed upon directors the duty of installing an internal control system to prevent repeated antitrust violations." *Id.* at 684.

tually present[ing] issues of business judgment,"[80] *Graham*'s language was, in one respect, an historic "first" for Delaware courts. With *Graham*, the Delaware Supreme Court broke new ground in corporate law by recognizing a director's fiduciary duty to act in a careful and prudent manner. But the accomplishment was diminished by the tentative and almost begrudging manner in which the court embraced this new-found duty to be expected of corporate fiduciaries seeking to invoke the business judgment rule of judicial deference. The court's language epitomizes the degree of deference with which Delaware courts had previously accorded management and the abject reluctance of Delaware courts to review the actions of directors found to be disinterested and not otherwise lacking in good faith.

In contrast, by 1963, legislatures of a number of states had enacted statutes defining a director's fiduciary duty of care. In 1968, Pennsylvania Business Corporation Law included a definition of a director's fiduciary duty of care:

> Relation of Directors and Officers to Corporation.—Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs.[81]

The statutes of many states were patterned after the Model Business Corporation Act. That Act defined a director's fiduciary duty in the following terms:

> A director shall discharge his duties as a director, including his duties as a member of a committee:
> (1) in good faith;
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
> (3) in a manner he reasonably believes to be in the best interests of the corporation.[82]

In Delaware, by contrast, the Delaware General Corporation Law left to the courts the responsibility to define the fiduciary duties of directors.[83]

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80. *Aronson*, 473 A.2d at 813 n.7.
81. PA. STAT. ANN. tit. 15, § 1408 (1967).
82. 2 MODEL BUSINESS CORP. ACT ANN. § 8.30(a) (1990).
83. *See* FOLK, *supra* note 62; *see also* DEL. CODE ANN. tit. 8, § 141(a) (1991).

However, Delaware decisional law continued to provide no clear beacon in terms of defining the parameters of a disinterested director's fiduciary duties of care. In 1967, in *Meyerson v. El Paso Natural Gas Co.*,[84] the court, relying on forty-year-old precedent, reiterated Delaware's oft-stated business judgment standard: Delaware courts will not interfere with the business judgment of directors absent a showing of "gross and palpable overreaching" by the directors over the shareholders.[85] In 1971, the Delaware Supreme Court opinion in *Sinclair Oil Co. v. Levien* was interpreted as extending the rule's presumption to any director action which could be "attributed to any rational business purpose."[86] Folk summarized his interpretation of Delaware decisional law regarding what types of director misconduct would overcome the business judgment rule:

> [D]irectors' actions are outside of the protection of the business judgment rule on finding "fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders," or "fraud or gross abuse of discretion," or "bad faith in the transaction," or if the transaction is "so manifestly unfair as to indicate fraud," or if there is "a showing of 'gross and palpable overreaching.' " After all, directors and officers must exhibit "honesty, good faith and loyal conduct" in their positions of "trust and confidence."[87]

In 1971, Chancellor William Duffy, shortly to become a justice of the Delaware Supreme Court, broke new ground in this field in *Kaplan v. Centex Corp.*[88] Chancellor Duffy, applying the dicta in *Graham v. Allis-Chalmers*, found an enforceable duty of care component in the Delaware business judgment rule.[89] *Kaplan* is a seminal case

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84. 246 A.2d 789 (Del. Ch. 1967).

85. *Id.* at 792.

86. *Sinclair*, 280 A.2d 717, 720 (Del. 1971). *See* FOLK, *supra* note 62, § 144, at 78. Arsht would later criticize Ernest L. Folk, III's interpretation of Delaware's business judgment rule for placing on a stockholder "the seemingly impossible task of proving 'irrationality.' " S. Samuel Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 656 (1979).

87. FOLK, *supra* note 62, at 76 (footnotes omitted). *See* Wolfensohn v. Madison Fund, Inc., 253 A.2d 72, 76 (Del. 1969); Moskowitz v. Bantrell, 190 A.2d 749, 749-50 (Del. 1963).

88. 284 A.2d 119 (Del. Ch. 1971).

89. *Id.* at 124-25.

because it found defendant directors to have lost the protection of the business judgment rule and to be liable to their shareholders for breach of their duty of care. Duffy ruled:

> Application of the [business judgment] rule of necessity depends upon a showing that informed directors did, in fact, make a business judgment authorizing the transaction under review. And, as plaintiff argues, the difficulty here is that evidence does not show that this was done. There were director-committee-officer references to the realignment but none of these, singly or cumulatively, show that *director judgment was brought to bear with specificity on the transactions.*[90]

A director's duty of care was again recognized the following year in *Penn Mart Realty Co. v. Becker.*[91] The court of chancery invoked trust law in observing that corporate directors may breach their fiduciary duty in ways other than simply breach of duty of loyalty.[92] The court stated that directors may be found to have breached their duty of care if the court finds them to have been grossly negligent.[93]

In 1974 the court of chancery, in *Gimbel v. Signal Companies,*[94] granted injunctive relief after finding substantial questions raised as to whether the board of directors of the parent company had made an informed judgment in approving the transaction.[95] Applying *Kaplan*, the court made clear that the director duty of care was distinct from, and not merely a surrogate of, the duty of loyalty. The court stated:

> Actual fraud, whether resulting from self-dealing or otherwise, is not necessary to challenge a sale of assets. And although the language of "constructive fraud" or "badge of fraud" has frequently and almost traditionally been used, such language is not very helpful when fraud admittedly has not been established. There are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based

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90. *Id.* at 124 (emphasis added).
91. 298 A.2d 349 (Del. Ch. 1972).
92. *Id.* at 351.
93. *Id.*
94. 316 A.2d 599 (Del. Ch. 1974), *aff'd*, 316 A.2d 619 (Del. 1974).
95. *Id.* at 615-18.

simply on gross inadequacy of price. This is clear even if language of fraud is used.[96]

The decisions of the Delaware courts in the early 1970s, finding a duty of care component within the Delaware business judgment rule, did not occur in a vacuum. The times were changing, both in terms of the social-political climate and in the courts throughout the country concerning the nature and scope of the fiduciary relationship of directors to their public shareholders. Corporate governance had become the battle cry for reform. Criticism understandably focused on Delaware because of the preeminence of its body of decisional and statutory law.

Leading the battle cry for corporate governance reform in the late 1960s and early 1970s was Professor William Cary of Columbia. In 1973 Cary called for national standards to replace what he considered the *laissez-faire* attitude of Delaware courts in permitting managers of public corporations to act with what he deemed to be indifference to the rights of minority shareholders.[97] Other writers of note, expressing similar complaints, called for reform in the composition of public corporations' boards of directors. Peter Drucker argued that boards of directors were no more than "an important ceremonial and legal fiction" that "do not function" and only "rubber stamp" the actions of management.[98] Drucker advocated the election to boards of " 'professional' directors, men or women of public standing and proven competence who, as members of the board, can be truly independent of management."[99]

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96. *Id.* at 610.

97. *See* Cary, *supra* note 79, at 683, 696. Professor Cary suggested there were several basic principles which needed recognition:

> The first is to recognize the importance of an independent and impartial judiciary. The second is to preserve public policy as a standard to be observed by the courts. The third is to emphasize the need for uniformity, so that states shall not compete with each other by lowering standards for competitive reasons or for the purpose of generating revenue. Finally, there should be as much federal concern about the management of the public issue company and about its share owners as about the investor engaged in the purchase and sale of its stock.

Id. at 697.

98. PETER F. DRUCKER, MANAGEMENT: TASKS, RESPONSIBILITIES, PRACTICES 627-29 (1973).

99. PETER F. DRUCKER, THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA 91 (1976). Another early advocate of corporate board reform was Professor Harvey Goldschmid of Columbia. Harvey J. Goldschmid, *The Greening of the Board Room: Reflections on Corporate Responsibility*, 10 COLUM. J.L.

By 1978, the SEC required disclosure by public corporations of the independence of directors, whether corporations maintained audit, nominating, and compensation committees, and whether incumbents had attended less than seventy-five percent of board meetings.[100] In 1978, the Committee on Corporation Laws of the American Bar Association's Corporation Banking and Business Law Section issued *The Corporate Director's Guidebook*. The *Guidebook* encouraged large public corporations to appoint non-management directors and to require audit, compensation, and nomination committees to be composed only of outsiders. Finally, in 1978 the Business Roundtable concluded that non-management directors should constitute a majority of a board of a widely held, publicly owned corporation.

In the prior year, 1977, influential members of the Delaware Bar who constituted the General Corporation Law Committee of the State Bar had concluded it was time for Delaware lawyers to come to the defense of Delaware corporation law. The Committee took what may have been an unprecedented step in undertaking to make a collective, and otherwise anonymous, response to the clamors for "Federal Chartering of Corporations," proposed by Cary in 1973, endorsed by Schwartz in 1976[101] and followed up by Nader, Green, and Seligman.[102] The Delaware Corporation Law Committee, in a somewhat defensive and beleaguered manner, defended the State of Delaware statute and decisional law in stating:

> [T]he Delaware legislature and courts do not lean over backward to assist and defend management; nor do they show undue partiality to the interests of the creditor, shareholder or the government. A fair analysis of Delaware corporation law shows it to be firmly rooted in equitable principles and administered by knowledgeable courts. Once in court the facts of the case, the law, and the court's conscience have in the past, and very likely will in the future, determine the result.[103]

& SOC. PROBS. 15, 17-28 (1978). Professor Goldschmid believed the "board's most important function is to actively check management." *Id.* at 24.

100. SEC, Shareholder Communications, Corporate Shareholder Participation in the Corporate Electoral Process and Governance Generally, Exchange Act Release No. 15,384, 43 Fed. Reg. 58,522 (Dec. 6, 1978).

101. Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

102. RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976).

103. *Resource Document on Delaware Corporation Law*, 2 DEL. J. CORP. L. 176 (1977).

The writers endeavored a definition of the Delaware business judgment rule in the context of the Delaware General Corporation Law and, in particular, section 141.[104] The Committee stated: "Overshadowing specific duties, a long and unchallenged line of Delaware cases makes clear that the primary duty of a director is, as a fiduciary, to deal fairly and justly with the entrusted assets in pursuit of the business objectives of the corporation."[105] The Committee referred to a 1941 decision of the Delaware Court of Chancery in *Yasik v. Wachtel*,[106] for a definition of a director's fiduciary duty:

> It is fundamental that directors stand in a fiduciary relation to the corporation and its shareholders, and that their primary duty is to deal fairly and justly. It is a breach of this duty, wholly apart from any consideration of preemptive rights, for directors to make use of the issuance of shares to accomplish an improper purpose, such as to enable a particular person or group to maintain or obtain voting control, against the objection of shareholders from whom control is thereby wrested.[107]

The Committee then stated that the business judgment rule would only apply to corporate officials who "have paid informed attention to their duties,"[108] as defined in 1971 by then Chancellor Duffy in *Kaplan v. Centex Corp.*[109] The Committee defined the elements and operation of the business judgment rule with the following language:

> It is said that the business judgment rule, when applicable, creates a presumption of good faith and requires a showing of bad faith or abuse of discretion to mount a successful challenge. This presumption, however, can be rebutted altogether, as in a situation of self dealing, or where the directors have passed "an unintelligent or unadvised judgment." The rule can also lose a portion of its force if, for example, the questioned transaction was hastily executed. In a situation where full director attention is questionable, the court may scrutinize carefully the ques-

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104. DEL. CODE ANN. tit. 8, § 141 (1991).

105. *Resource Document on Delaware Corporation Law*, *supra* note 103, at 185.

106. 17 A.2d 309 (Del. Ch. 1941).

107. *Resource Document on Delaware Corporation Law*, *supra* note 103, at 185-86 (quoting Yasik v. Wachtel, 17 A.2d 309, 313 (Del. Ch. 1941)).

108. *Id.* at 186.

109. 284 A.2d 119 (Del. Ch. 1971).

> tioned transaction while still granting some quantum of weight to the presumption of sound business judgment.[110]

The Committee, in a conclusion to its "Resource Document," expressed the hope that its undertaking would lead to "a greater understanding . . . of the [Delaware Corporation] law, and an understanding of the courts' concern for a fair balancing of the interests of all parties to corporate disputes."[111] What response or comments the Committee received is not known.

What is known is that, apparently, at least one prominent member of the Delaware corporate bar felt more was required to stem the continuing criticism "from abroad" of Delaware corporation law in general and the role of Delaware courts in the enforcement of its law. As noted above, S. Samuel Arsht felt that the root of the criticism lay with the operation of the Delaware business judgment rule.

Arsht first offered his views on the subject in February 1979 in a paper delivered at a Delaware Corporation Law Seminar at the Delaware Law School, now Widener University School of Law.[112] Arsht's paper was titled, "The Business Judgment Rule in Delaware and its Applicability to the Fiduciary Responsibilities of Directors, Officers and Controlling Stockholders." His paper, never published, explained the motivating reasons for his undertaking the study. He stated:

> In recent years, Delaware's standards which govern the performance by a director, key officer or controlling stockholder of the fiduciary duty he owes to his corporation and its stockholders have been under attack; frequently on the wholly inaccurate premise that Delaware law is tantamount to a license to mismanage or to deal unfairly with stockholders and that Delaware courts will not enforce even minimal standards.
>
> The aspect of Delaware law that draws the hottest fire is Delaware's so-called "Business Judgment Rule." That

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110. *Resource Document on Delaware Corporation Law*, *supra* note 103, at 186-87 (footnotes omitted).

111. *Id.* at 205.

112. S. Samuel Arsht, *The Business Judgment Rule in Delaware and its Applicability to the Fiduciary Responsibilities of Directors, Officers and Controlling Stockholders* (1979) (paper presented at the Delaware Corporation Law Seminar, Delaware Law School, Feb. 15, 1979) (on file with *The Delaware Journal of Corporate Law*).

> rule must be the least understood of corporate law concepts.[113]

In an interestingly-phrased letter of transmittal of his earlier unpublished "paper" to the then members of the Delaware Supreme Court and the Delaware Court of Chancery, Arsht stated that "[s]ince the opinions expressed in the paper are controversial, no acknowledgement or comment is necessary."[114]

Later the same year, Arsht expanded on his paper in an article published in the *Hofstra Law Review*.[115] There, Arsht stated that the business judgment rule, though a recognized common law principle of corporate governance for at least 150 years, was grossly misunderstood.[116] He attributed the misunderstanding of the rule's use to a "general failure to distinguish the business judgment rule from the presumptions and limitations that surround the rule's application and [to] the tendency of [even Delaware] courts to use loose language in expressing the rule."[117] Arsht explained:

> I was invited by the *Hofstra Law Review* to contribute an article for a symposium on corporate governance. Although the invitation was probably extended in the expectation that I would again take the side of state as opposed to federal chartering and regulation of corporations, I chose, instead, to write again on the business judgment rule because, in my view, it is a misunderstood corporate law concept and the misunderstanding, rooted in Delaware decisions, serves to fuel the fires of those who advocate replacing state with federal corporate law.[118]

After examining various, assertedly incomplete, formulations and applications of the rule under existing Delaware decisional law, Arsht concluded that the usual statement of the rule's purpose, to insulate from liability "[a] director who diligently attends to his or her duties

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113. *Id.* at 1 (citations omitted).

114. Letter from S. Samuel Arsht, Esquire, of Morris, Nichols, Arsht and Tunnell to The Honorable Daniel L. Herrmann, Chief Justice, Delaware Supreme Court et al. (Feb. 20, 1979) (on file with *The Delaware Journal of Corporate Law*).

115. Arsht, *supra* note 23, at 93.

116. *Id.* at 93-94.

117. *Id.*

118. Letter from S. Samuel Arsht, Esquire, of Morris, Nichols, Arsht and Tunnell to The Honorable Daniel L. Herrmann, Chief Justice, Delaware Supreme Court et al. (Sept. 13, 1979) (on file with *The Delaware Journal of Corporate Law*).

and exercises his or her best business judgment on the questions facing the board," was "too compact."[119] Did Arsht also mean "too simplistic"? Arsht then offered his own restatement of the business judgment rule by redefining the elements and limits of the business judgment rule as follows:

> A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, *unless*:
>
> (1) *the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or*
>
> (2) the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; *or*
>
> (3) in some other way the directors' authorization of the transaction was not in good faith.[120]

Arsht's article received wide publicity both in Delaware and abroad. Barely five years later, the Delaware Supreme Court in *Aronson v. Lewis*[121] had placed a concept of the standard of care expected of directors into Delaware's business judgment rule. The standard represented a synthesis of *Kaplan v. Centex*,[122] the dicta of *Graham v. Allis-Chalmers Manufacturing Co.*[123] and language closely paralleling Arsht's restatement of the rule.[124] Justice Andrew G. T. Moore, II, speaking for this court in *Aronson*, stated:

> [T]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware

119. Arsht, *supra* note 23, at 111.
120. *Id.* at 111-12 (emphasis added).
121. 473 A.2d 805 (Del. 1984).
122. 284 A.2d 119 (Del. Ch. 1971).
123. 188 A.2d 125 (Del. 1963).
124. *See supra* text accompanying note 23.

> cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.[125]

Aronson provided the keystone for the supreme court's later rulings in *Smith v. Van Gorkom*[126] and *Cede & Co. v. Technicolor.*[127]

Had Arsht's analysis of the shortcomings of the Delaware business judgment rule been heeded earlier, the decision of the supreme court in *Smith v. Van Gorkom* may have been more foreseeable.

This paper is not intended to be viewed as a defense of the Delaware Supreme Court's decision in *Smith v. Van Gorkom* or the court's more recent 1993 decision in *Cede v. Cinerama.* To that end, this historical analysis of the relationship of the duty of care to the business judgment rule will end with *Aronson.* Other commentators may wish to relate those decisions to this undertaking. But one observation may be offered: The legal reasoning underlying the results in *Smith v. Van Gorkom* and *Technicolor* have solid precedent in *Aronson* in their recognition of a director's fiduciary duty of care. *Cede II* may also be viewed as a logical and predictable application of the duty of care component of our business judgment rule as formulated by the Delaware Supreme Court and expressed in its decisional law since at least 1963. Others may also wish to consider the consequences of our legislature's enactment of section 102(b)(7)[128] to the continued viability within the operation of the business judgment rule of directors' fiduciary duty of care to their corporation and its shareholders.

IV. CONCLUSION

In the first half of the twentieth century our supreme court functioned, in the words of some, as a "court of leftover judges."

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

126. 488 A.2d 858 (Del. 1985).

127. 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

128. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). Section 102(b)(7) was enacted shortly after the decision in *Smith v. Van Gorkom* and, in part, provides that a Delaware corporation's articles may contain:

> [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of a fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders . . . .

Id.

Our court of chancery and supreme court appeared not only to academicians, but also to at least one respected and distinguished corporate practitioner in the Delaware Bar, to render less than a stellar performance in (a) articulating the proper standard of a corporate fiduciary's duty of care, and (b) in relating that duty to a proper formulation and application of the business judgment rule. In the past forty years the Delaware judiciary, and in particular the supreme court, as reconstituted in 1951 as a separate and independent court within our judicial system, may be said to have redressed the balance (and tension) between the operation of the business judgment rule and the presumptions required to invoke the rule. Today, for the rule to be invoked in Delaware on behalf of a disinterested corporate fiduciary, the officer or director must not simply be found to have acted in good faith and in a manner felt to be in the best interest of the corporation, but also in an informed manner; that is, in the manner originally described by our supreme court in *Graham v. Allis-Chalmers*, and later applied by the court of chancery in *Kaplan*, and as later clarified by our court in *Aronson v. Lewis* and ultimately applied in *Smith v. Van Gorkom* and *Cinerama v. Technicolor II*. Delaware law may now be seen, at least by some, as having returned to the mainstream of corporate governance as practiced in America today.[129]

To what should we attribute our court's redress of the operation of the business judgment rule in Delaware? I think, in no small part, to the restructuring and independence of our judiciary, and especially our supreme court. In my view, the structure and composition of our supreme court, in conjunction with the method and selection of our judiciary through a carefully constructed screening process, has enabled the Delaware judiciary, in particular the Delaware Supreme Court as now constituted, to achieve a level of performance which has brought the court to national, if not international, preeminence.

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129. Recently, the board of General Motors Corporation made "permanent the revolution in the role of corporate directors that [it had] launched two years ago" by establishing guidelines formalizing stronger control by independent board members over management and more direct access of the board to management. Robert L. Simison, *GM Board Adopts Formal Guidelines On Stronger Control Over Management*, WALL ST. J., Mar. 28, 1994, at A4. Some of these reforms echo Dent's suggestions for a "monitoring model" of corporate governance. Dent, *supra* note 20. This internal, "voluntary" reform will likely trigger other such reform within American corporations. *Id.*