OUTSIDE DIRECTORS: THEIR IMPORTANCE TO THE CORPORATION AND PROTECTION FROM LIABILITY

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I. INTRODUCTION

Directors of corporations have never been more at risk—at least that is their perception—than they are today.[1] Their exposure extends not only to the loss of their personal fortunes in class and derivative actions, but also to fines, penalties, and punitive damages and, in rare cases, even to imprisonment for violations of state and federal laws.[2]

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1. *See* Silas, *Risky Business, Corporate Directors Bailout*, 72 A.B.A. J. 24 (June 1986) [hereinafter Silas, *Risky Business*]; Behar & Clifford, *Kibitzing From the Boardroom*, FORBES, Feb. 10, 1986, at 70; KORN/FERRY INTERNATIONAL, BOARD OF DIRECTORS THIRTEENTH ANNUAL STUDY, Feb. 1986 [hereinafter KORN/FERRY]. Five hundred ninety-two companies participated in the Korn/Ferry Study. The industrial companies varied in size from 26 with assets of under $200 million to 70 with assets of $5 billion and over. Banks and other financial institutions, insurance companies, retailers, and service companies also participated. *Id.* at 23. For the purposes of this article, a corporation is a large publicly held corporation. The definition of the American Law Institute is used:

> "Large publicly held corporation" means a corporation that as of the record date for its most recent annual shareholders' meeting had both 2,000 or more record holders of its equity securities and $100 million of total assets; but a corporation shall not cease to be a large publicly held corporation because its total assets fall below $100 million, unless total assets remain below $100 million for *two* consecutive fiscal years.

ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.16 (Tent. Draft No. 2, 1984) [hereinafter ALI Draft No. 2].

2. Joseph P. De Alessandro, president and CEO, National Union Fire Insurance Company of Pittsburgh, has stated that "in settlement modes there are contributions of a major nature made by directors. I know of contributions on an

In the past directors believed they were protected from liability by the directors and officer (D&O) liability insurance carried by the companies on whose boards they served. Although the many limitations or exclusions in D&O policies justifiably caused some to question their value,[3] nonetheless D&O insurance was purchased to attract and retain qualified outside directors. Owing to recent heavy losses and uncertainty as to their liability, the number of carriers of D&O liability insurance has been significantly reduced.[4] Moreover, the remaining insurers do not favor coverage for corporations in businesses such as finance, high technology, utilities, real estate, petrochemicals, and steel. In some cases carriers have cancelled the insurance. In other cases the premiums have been increased to such high rates that the insureds have not renewed their coverage.[5]

Without insurance, directors must rely on indemnification as provided in state statutes, charters, and bylaws. Although indemnification may well provide more protection than insurance, directors have never felt that indemnification protected them adequately. Under the General Corporation Law of Delaware (DGCL), directors and officers may not be indemnified for judgments or amounts paid in settlements in derivative actions, even where there are no alle-

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individual basis that have exceeded several million dollars." DIRECTOR ROUNDTABLE: THE D&O CRISIS AND BOARD LIABILITY, DIRECTORS & BOARDS 11 (Summer 1986). *See also* Spiegel, *The Liability of Corporate Officers*, 71 A.B.A. J. 48 (Nov. 1985); United States v. Park, 421 U.S. 658 (1974); Transcript from NBC Nightly News Special Segment with Tom Brokaw 7-10 (May 21, 1986); Cahan, Frank & Moskowiz, *A Murder Verdict Jolts Business*, Bus. Wk., July 1, 1985, at 24; M. CLINARD & P. YEAGER, CORPORATE CRIME (1980). This book, for example, notes the marked increase in fines of corporate officials for antitrust violations from 1974, when Congress increased the penalties, to 1980. In mid-1979, a federal judge imposed a total of $650,000 in fines on 13 executive defendants after they pleaded no contest to price-fixing charges. *Id.* at 153.

3. *See* Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 2012 (1978) [hereinafter Johnston, *Liability*]; Herzel, *The Crisis in D&O Insurance and Proposed Legislation Concerning Corporate Indemnification Liability Caps and Higher Standards for Liability in Derivative Suits*, in ALI-ABA VIDEO LAW REVIEW STUDY, PROTECTING DIRECTORS AND OFFICERS IN AN ERA OF UNCERTAIN D&O LIABILITY INSURANCE 99, 101 (1986) [hereinafter Herzel, *Crisis*]; THE WYATT COMPANY, DIRECTORS AND OFFICERS AND FIDUCIARY LIABILITY SURVEY 28-30 (1984) [hereinafter WYATT].

4. *See* Schauer, *Ailing D&O Insurance Market Looks for Cure*, 6 BUS. LAW. UPDATE No. 4, at 1 (Mar./Apr. 1986) [hereinafter Schauer, *Cure*]; Goldwasser, *An Overview of Directors' and Officers' Liability and Self Insurance* 11, 15-16, in DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND SELF INSURANCE 381 (PLI 1986) [hereinafter Goldwasser, *Insurance*].

5. *See* Goldwasser, *Insurance, supra* note 4.

gations of fraud, bad faith, or self-dealing. As discussed in this article, there is respectable opinion both in the business and academic communities that the boards of the larger corporations should have, if not a majority, a significant number of independent or outside directors. However, because of the insurance crisis and the increased exposure to personal loss, many directors in recent months have resigned. Moreover, it is becoming difficult for companies to replace these directors with qualified persons.[6] Many responsible persons concerned with the proper governance of corporations are alarmed at this development.

It may be that amendments to the DGCL enacted in June of 1986 and effective on July 1, 1986, and similar laws of other jurisdictions providing for the elimination or limitation of liability for violation of certain fiduciary duties will help to alleviate the director liability crisis, but it is premature to make any sound predictions.[7]

This article is concerned primarily with the issue of liability of outside directors under the DGCL. I shall first discuss, from both a business and legal standpoint, the value and importance of the presence of outside directors on the board of any large publicly held corporation. Next, I shall explore whether there is any basis for asserting that a different standard of care should apply to outside directors. I shall also review the various means whereby directors are protected from liability under statutory and decisional law and D&O insurance. The article will also review the recent amendments to the DGCL whereby a corporation's charter may be amended to eliminate or limit the liability of directors who have violated their duty of care. The article is not concerned with the directors' violation of the duty of loyalty and the discussion is primarily related to Delaware law.

II. INSIDE AND OUTSIDE DIRECTORS

It will be useful if there is an understanding of the term "outside" director as used in this article. Not all experts in the governance of corporations describe inside and non-inside directors alike. For example, the *Corporate Directors Guidebook* designates directors as man-

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6. *Business Struggles to Adopt as Insurance Crises Spreads*, Wall St. J., Jan. 21, 1986, at 31, col. 5; Schauer, *Cure, supra* note 4, at 1; KORN/FERRY, *supra* note 1, at 1-2; Silas, *Risky Business, supra* note 1, at 24.

7. *See infra* notes 267-86 and accompanying text.

agement or non-management.[8] A management director is one who devotes substantially full time to the affairs of the corporation or its subsidiaries and thus may not be deemed independent.[9] However, the *Guidebook* recognizes that certain non-management directors may have associations or relationships that place doubt on their independence. These directors are characterized as "affiliated non-management" directors and include directors who: (1) formerly were officers or employees of the corporation; (2) are commercial bankers, investment bankers, attorneys, and others who supply services or goods to the corporation; or (3) have close familial ties to members of key management. The "unaffiliated non-management director" is determined by the "judgment of the board . . . that the individual is free of any relationship which would interfere with the exercise of his independent judgment" as a member of the board or a board committee on which he serves.[10]

The Business Roundtable, an organization of chief executive officers of some 200 large publicly held corporations, distinguishes between "inside" and "outside" directors, but notes that there is a question about the "outsideness" of retired officers, bankers, lawyers, and others who in some way serve the corporation.[11]

One author suggests three classes of identifiable directors.

> The inside director, which includes officers and employees of the company, non-independent outside directors, which include consultants to the company such as attorneys, bankers and investment bankers whose corporations provide the company with regular services and relatives of inside directors; and independent outside directors who have no present direct business relationship with the corporation on whose board they serve.[12]

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8. *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1619-20 (1978) [hereinafter *Guidebook*]. A subcommittee of the Section on Corporation, Banking and Business Law of the American Bar Association drafted the *Guidebook*. It has since been accepted by the Council of the Section on Corporation, Banking and Business Law.

9. *Id.* at 1619.

10. *Id.* at 1620.

11. *Statement of Business Roundtable*, 33 BUS. LAW. 2085, 2107 (1978) [hereinafter *Roundtable*].

12. Cohen, *The Outside Director—Selection, Responsibilities and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837-38 (1977). The Investment Company

The New York Stock Exchange requires that newly listed companies have at least two independent directors. Further, as a condition of continued listing, companies must have an audit committee composed of one or more directors who are independent of management and who are free of a relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as a committee member. For this purpose, officers, employees, and affiliates would not be qualified, but a former officer may qualify if the board determines that he will exercise independent judgment.[13]

The American Law Institute (ALI), in its recommendations on corporate governance, does not use terms such as outside or "independent" directors. It distinguishes between directors who are senior executives, directors who have a significant relationship with senior executives, and those who are free of such relationships. The definition of significant relationship includes directors who are or were employees of the corporation in the recent past or who recently had a significant commercial relationship with the corporation. In addition, the principal manager of another company would be deemed to have a significant relationship with the corporation's management if the company did a significant amount of business with that corporation. Finally, a significant relationship exists if directors are affiliated with a law firm or investment banking firm that served as an adviser in the recent past.[14]

For the purposes of this article, "outside" directors are those who are not affiliated with the company as officers or employees. Although this definition includes some affiliated non-management directors, or directors who have a significant relationship to senior executives as defined above, no distinction is made between them in this discussion. The courts, in distinguishing between inside and outside directors, generally will single out the director who has a relationship with the corporation that will compromise his independence.[15]

Act of 1940 requires that 40% of the directors of a registered company not be interested persons. 15 U.S.C. § 80a-10(a) (1981).

13. *See* R. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 563-64 n.20 (3d ed. 1986) [hereinafter HAMILTON]. *See, e.g.*, NEW YORK STOCK EXCHANGE, INC., COMPANY MANUAL PA-29.

14. ALI Draft No. 2, *supra* note 1, at § 1.26(1)(a) -.26(1)(e).

15. *See* MacAndrews & Forbes Holding, Inc. v. Revlon, Inc., 501 A.2d 1239, 1243 n.2 (Del. Ch. 1985).

III. THE VALUE OF OUTSIDE DIRECTORS

A. *The Advantage of Outside Directors in Corporate Governance*

Although there is not unanimity as to the benefit to the corporation of outside directors or the proper mix of outside and inside directors, most persons in academia and business agree that outside directors play an important role in the effective functioning of the board. Irving S. Shapiro, former chairman of the Du Pont Company and a leading spokesman for business of the past decade, stated that if the directors are "to help to provide informed and principled oversight of corporate affairs, a good number of them must provide windows to the outside world."[16] He added that this is "at least part of the rationale for outside directors, and especially for directors who can bring unique perspective to the group."[17]

The Roundtable advises that, at a minimum, the number of outsiders should be sufficient to have a substantial impact on the board decision process—a number referred to as the "critical mass."[18] The board, according to the Roundtable, should have a central core of experienced business executives so that the management of the corporation may consult with directors who have experienced comparable problems. In addition, the Roundtable recommends that the board have directors from outside the business community who have had substantial experience in public life or in academic or scientific activities.[19] It also refers to the importance of outside directors on what it describes as the three critical committees—Audit, Compensation, and Nominating Committees.[20] Moreover, the Roundtable recommends all outside directors for the Audit and Compensation

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16. I. Shapiro, *Corporate Governance*, in FAIRLESS LECTURE SERIES, CARNEGIE-MELLON UNIVERSITY 11 (Oct. 24, 1979).

17. *Id.* Mr. Shapiro was chairman and chief executive officer of E.I. du Pont de Nemours and Company from 1974 to 1981 and chairman of the Finance Committee from 1981 to 1986.

Although this discussion concerns the importance and value of outside directors, I do not intend to minimize the importance of inside directors. Inside directors perform important roles, such as providing direction to the Board and serving as sources of information.

18. *Roundtable*, *supra* note 11, at 2108.

19. *Id.* at 2105.

20. Other board committees include the Executive, Finance, Benefits, Public Affairs, Corporate Ethics, and Science/Technology Committees. KORN/FERRY, *supra* note 1, at 15. According to this study, on the average these committees are composed of a majority of outside directors. *Id.* The *Roundtable* rejects constituency directors—

Committees and a majority of outside directors for the Nominating Committee.[21]

The *Guidebook* assigns a monitoring role to directors in functions where the outside directors would likely have a major role. Their duties are to:

1. Review and confirm basic corporate objectives.
2. Select competent senior executives and monitor personnel policies and procedures with a view to assure that the enterprise is provided with other competent managers in the future.
3. Review the performance of senior managers thus selected and monitor the performance of the enterprise.[22]

The ALI proposal recommends that the majority of the board of directors not have a significant relationship with management and that their governance function be the oversight of principal senior executives, the conduct of the corporation's business, and major corporate plans and commitments of corporate resources.[23] The ALI also would require that corporations have audit committees composed of directors who have no significant relationship with senior man-

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directors responsible to a particular claimant group. It is stated that these directors would introduce to the board a divisive and adversary atmosphere which would obstruct the effective performance of the enterprise. *Roundtable, supra* note 11, at 2106.

This argument has also been offered by many companies in response to stockholder proposals for cumulative voting. For example, the 1985 Du Pont Proxy Statement, after noting that it had opposed this resolution each of the seven times it had been proposed before since 1955, stated that cumulative voting is not in the best interests of the corporation. Further,

> [i]n the opinion of the Board, cumulative voting would permit the election of one or more directors for the sole purpose of supporting a particular point of view, without regard to the interests of other parties. Directors elected in this manner could not be expected to exercise free judgment and would not represent the stockholders as a whole.

E.I. DU PONT DE NEMOURS AND COMPANY, INCORPORATED, PROXY STATEMENT FOR THE 1985 ANNUAL MEETING 22.

21. *Roundtable, supra* note 11, at 2108.

22. *Guidebook, supra* note 8, at 1607, 1625. *See also* STAFF OF SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 96TH CONG., 2D SESS., REPORT OF THE S.E.C. ON CORPORATE ACCOUNTABILITY 549-53 (Comm. Print 1980); M. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 156 (1976); Hahn & Manzoni, *The Monitoring Committee and Outside Directors' Evolving Duty of Care*, 9 LOY. U. L.J. 587 (1978) [hereinafter Hahn & Manzoni, *Duty*].

23. ALI Draft No. 2, *supra* note 1, §§ 3.02, .04. *See* Kaplan, *Misconceptions About the ALI Corporate Governance Project and the Role of Criticism*, 9 DEL. J. CORP. L. 586, 589 (1984) [hereinafter Kaplan, *Misconceptions*].

agement and recommends that nominating and compensation committees be composed of a majority of such directors.[24]

Not everyone agrees that outside directors serve a useful function. Former Professor (now Judge) Easterbrook states that it is unlikely that outside directors could improve the position of investors and that unless they spend full time "at the firm," they will never know enough to fulfill their monitoring functions.[25] Professor Werner of Columbia University School of Law argues that shareholders are not interested in whether directors are inside or outside or if there is corporate democracy. He asserts that the stockholders rate the performance of management and vote under the so-called "Wall Street Rule"—by buying and selling shares.[26] Professor Brudney of Harvard Law School criticizes the independent-director model because in his view outsiders do not have the time, knowledge, or incentive to perform the role of enforcing management integrity or performance.[27]

These critics notwithstanding, as an observer of board meetings of a large publicly held corporation for a number of years, I believe that outside directors perform useful and important functions. The fact that the board includes members who are experienced executives from other companies, scientists, and academicians has a beneficial effect on the performance of management. Certainly, as they should, outside directors play an important role in the orderly transition of top management and in recommending effective new outside members of the board when they are needed. Outside directors, especially those who are or have been key executives in other companies, provide valuable insights in corporate decision making, serve as members of the important Audit Committee, and have a major role in determining the compensation of key management.

Moreover, they can perform useful, even critical, roles in emergencies. These include the replacement of an ineffective or incapacitated chief executive officer and the assurance of an orderly transition in the event of the retirement or death of the chief executive officer

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24. ALI Draft No. 2, *supra* note 1, §§ 3.03, .06, .07.

25. Easterbrook, *Managers' Discretion and Investors Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 555-56 (1984) (Judge Easterbrook serves on the Seventh Circuit Court of Appeals).

26. Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1643-44 (1981). *See also* Karmel, *The Independent Corporate Board: A Means to What End*, 52 GEO. WASH. L. REV. 534, 550-51 (1984).

27. Brudney, *The Independent Director—Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 616-22, 642-59 (1982).

or other key executives. There are times when outside directors are needed for emergencies such as service on a special litigation committee to investigate the desirability of pursuing derivative litigation,[28] or allegedly improper conduct of officers of the company.

An example of how outside directors help the company in an emergency is the part played by the outside directors of Union Carbide, who led the Carbide defense that fended off the GAF takeover attempt. One of these outsiders has been given credit for playing a dominant role in formulating the antitakeover strategy.[29] Another example appears in *Unocal v. Mesa Petroleum Co.*,[30] where the outside directors met separately with Unocal's financial advisors and attorneys before advising that the board should reject Mesa's offer as inadequate.[31]

As to the governance function of outside directors, there are strong views that the most effective model for a board is one having a majority of outsiders. Although outside directors serve useful roles on corporate boards, a pat formula approach that requires a majority of outside directors for the board of every large publicly held corporation is questionable at best.[32] What is a proper board for one company may not be good for another, and the better view is that each corporation should be free to determine what is suitable for its needs.[33]

The Roundtable states a preference for a majority of outside directors as follows: "It is our belief that in most instances—there will be exceptions based on the particular situation of an enterprise—it is desirable that the board be composed of a majority of [outside] directors."[34]

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28. *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Pease, Aronson v. Lewis: *When Demand is Excused and Delaware's Business Judgment Rule*, 9 DEL. J. CORP. L. 39 (1984) [hereinafter Pease, *Business Judgment Rule*].

29. *See* Wall St. J., Jan. 13, 1986, at 1, col. 6.

30. 493 A.2d 946 (Del. 1985).

31. *Id.* at 950. Recently, the outside directors of Viacom International, Inc. rejected a leveraged buyout bid by a group led by Viacom's senior management. New York Times, Oct. 8, 1986, at D1, col. 2. The recently adopted New York Stock Exchange rule permitting dual class stock requires both stockholder approval and approval by a majority of the company's independent directors. American Soc'y of Corp. Secretaries, Newsletter 1 (Aug. 1986) [hereinafter Newsletter].

32. *See* Seibert, *Keynote Address: The Dynamics of Corporate Governance*, 9 DEL. J. CORP. L. 515 (1984). He stated that a "good" board—one that is accountable, diligent, active, responsible, and successful—has little to do with whether directors are insiders or outsiders, or whether the board has certain committees. *Id.* at 518.

33. *Id.* at 519.

34. *Roundtable*, *supra* note 11, at 2108.

The ALI's Tentative Draft No. 1 required that large publicly held corporations have a majority of independent directors (individuals "free of any significant relationships . . . with the corporation's senior executives").[35] The project's former chief reporter recently noted that a "great deal of fury has been exhibited over the initial requirement in Part III that there should be a majority of directors not affiliated with management."[36] As a result, the "revised draft will eliminate the mandatory character of that particular requirement for a nonaffiliated majority, even though that requirement only applied to the large companies listed on the New York Stock Exchange."[37]

Regardless of the pros and cons of whether the outside directors should constitute a majority of the board, a 1986 survey of 592 companies showed that their boards had an average of 14 directors, of whom 10 were listed as outside and 4 inside.[38] Thus, at least these companies believe there is value in having a majority of outside directors. Moreover, as hereinafter discussed, there is a legal benefit in having such a majority.

B. *The Legal Advantage of Outside Directors*

In a series of cases, the Delaware courts have held that the decisions of boards with a majority of outside directors are entitled to certain beneficial presumptions. An early case stating this view is *Puma v. Marriott*,[39] a derivative suit in the court of chancery in which the plaintiff challenged an exchange of Marriott Corporation stock for interests in six other corporations. The plaintiff claimed that the property in the exchange was overvalued and that the Marriott stock given for the property was undervalued.[40] Moreover, he alleged that insiders were dealing with their own corporation and that since they were on both sides of the transaction, they had the

35. ALI, PRINCIPLES OF CORPORATE GOVERNANCE: RESTATEMENT AND RECOMMENDATIONS § 3.03(a) (Tent. Draft No. 1, 1982) [hereinafter ALI Draft No. 1].

36. Kaplan, *Misconceptions*, *supra* note 23, at 589. ALI Draft No. 1 was published as a "Restatement and Recommendations." However, critics argued that the project created new law and was not a restatement in the traditional sense, thus prompting the ALI to remove the word "Restatement" from its current drafts. ALI Draft No. 2, *supra* note 1, at vii-x, Foreword.

37. Kaplan, *Misconceptions*, *supra* note 23, at 589.

38. *See* KORN/FERRY, *supra* note 1, at 4, 13. These companies recruited outside directors from three primary sources: senior executives of other companies (82%), retired executives of other companies (68%), and academicians (55%).

39. 283 A.2d 693 (Del. 1971).

40. *Id.* at 695.

burden of establishing its entire fairness.[41] The court noted, however, that the decisions as to valuation were made by outside directors and that the plaintiff failed to show they were dominated by the insiders. The court continued: "No attempt was made to impugn the integrity or good faith of these outside directors, all of whom were men of experience in the business and financial world."[42] Further, since the valuations of the properties and the stock were made by a majority of Marriott directors whose independence was unchallenged, it could not be said that the Marriott group stood on both sides of the transaction.[43] The vice-chancellor thus concluded that since the transaction was the result of the exercise of the independent business judgment of the outside directors, the court was "precluded from substituting its uninformed opinion for that of the experienced, independent board members of Marriott."[44]

The Delaware Supreme Court in recent well publicized cases has pointed out the value of a majority of outside directors in adopting measures to discourage or defeat tender offers. The first of these is *Unocal Corp. v. Mesa Petroleum Co.*,[45] where Unocal succeeded in defeating Mesa's takeover attempt. In response to Mesa's two-tier tender offer, Unocal tendered for its own shares excluding Mesa from participation. The court said that in this situation, because of the "omnipresent specter" that a board of directors may be acting primarily in its own "interests," there is an "enhanced duty" that calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.[46] According to the court, there was an inherent conflict in the Unocal board's efforts to defeat a perceived threat that obligated the directors to show they had reasonable grounds "for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[47] This burden was satisfied by showing the board's good faith and reasonable investigation. The court then said that proof

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41. *Id.* The court cited an important Delaware Supreme Court decision setting forth the test of entire fairness when directors and stockholders stand on both sides of a transaction. Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 20, 93 A.2d 107 (1952).

42. *Puma*, 283 A.2d at 695.

43. *Id.*

44. *Id.* at 696.

45. 493 A.2d 946 (Del. 1985).

46. *Id.* at 954.

47. *Id.* at 955. For further discussion of the "enhanced duty," see *infra* notes 169-80 and accompanying text.

of these requirements was enhanced "by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards."[48]

Another case holding that a board with a majority of outside directors is entitled to certain favorable presumptions is *Moran v. Household International, Inc.*,[49] in which the Delaware Supreme Court held that the adoption of a preferred share purchase rights plan—a poison pill—was a legitimate exercise of the board's business judgment.[50] The court in *Household* restated the "enhanced duty" rule of *Unocal*. Thus, the court held that the directors must show they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.[51]

The court again discussed the importance of outside directors in meeting the board's burden. The opinion stated "that proof [of reasonableness and good faith] is materially enhanced where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards."[52]

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48. *Unocal*, 493 A.2d at 955. The SEC recently issued a regulation that provides that a bidder's or issuer's tender offer must be open to all holders of the class of the securities subject to the tender offer. 51 Fed. Reg. 25,873 (1986).

49. 500 A.2d 1346 (Del. 1985).

50. Under the rights plan adopted in *Household International*, if

> an announcement of a tender offer for 30 percent of Household's shares is made, the Rights are issued and are immediately exercisable to purchase 1/100 shares of new preferred stock for $100 and are redeemable by the Board for $.50 per Right. If 20 percent of Household's shares are acquired by anyone, the Rights are issued and become non-redeemable and are exercisable to purchase 1/100 of a share of preferred. If a Right is not exercised for preferred, and thereafter, a merger or consolidation occurs, the Rights holder can exercise each Right to purchase $200 of the common stock of the tender offeror for $100.

Id. at 1349. The "flip-over" provision of the Rights Plan was "at the heart" of this controversy. *Id.* There was no threat of a takeover when the "poison pill" was adopted by Household International.

51. *Id.* at 1356. A federal district court recently invalidated a poison pill applying New Jersey law. Amalgamated Sugar Co. v. N.L. Indus., Fed. Sec. L. Rep. (CCH) ¶ 92,857 (S.D.N.Y. 1986).

52. *Id.* at 1357. In this regard, the court cited the controversial case of Cheff v. Mathes, 199 A.2d 548 (Del. 1964). In this case the Delaware Supreme Court held that the directors, in the purchase by Holland Furnace Company of its own shares from an alleged raider, satisfied the burden of proof by showing they had reasonable grounds for believing a danger to corporate policy existed. Professor Cary in his famous "race to the bottom" article on Delaware corporation law decisions was particularly critical of this case. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 674-75 (1974). A commentator who disagreed with this criticism observed that in *Cheff*

The Delaware Supreme Court in *Polk v. Good*[53] declared the value of outside directors in approving the decision of Texaco, Inc. to repurchase shares of its own stock from a purportedly disruptive shareholders' group. The plaintiffs alleged that the repurchase of Texaco's stock from the Bass brothers group was improper because, *inter alia*, the price paid for the stock was excessive, the repurchase constituted a gift of corporate assets, and had the improper objective of entrenching Texaco's board.[54] The Bass group had acquired 9.9% of Texaco's issued and outstanding stock before and while Texaco was acquiring Getty Oil Company in one of the biggest corporate acquisitions in history.[55] The Bass group persisted in urging Texaco to repurchase their interest and threatened to purchase up to twenty percent of Texaco's stock with the view of a possible tender offer.[56] Texaco's management was concerned that the Bass group would use their holding of Texaco stock in a way that would be contrary to the best interests of a majority of the company's stockholders, particularly in relation to its efforts to acquire Getty. After consulting its investment banker and outside counsel, Texaco and its advisors all "concluded that a substantial immediate threat to the corporation's best interests existed and that the most effective way of meeting the danger was to acquire the Bass stock."[57] The parties agreed that Texaco would repurchase the shares at $50 each (a premium of $1 5/8 over the market price), one-half to be paid in cash and the other half in the form of a new issue of preferred stock. As part of the agreement, the Bass group agreed to vote the preferred stock as the

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> the Delaware Supreme Court did not accept the argument that the director defendants ultimately made, which was that the purchase of a corporation's own stock authorized by a board, a majority of whose members have no substantial financial stake in retention of control, is entitled to the benefit of the business judgment presumption.

Drexler, *Federalism and Corporate Law: A Misguided Missile*, 3 SEC. REG. L.J. 374, 379 (1976) (Holland Furnace did not have a majority of outside directors within the meaning discussed in this article).

53. 507 A.2d 531 (Del. 1986).

54. *Id.* at 534.

55. *Id.* at 533. The cost to Texaco of acquiring Getty was over $10 billion. *Id.* After this acquisition, Pennzoil Co., another suitor for Getty stock, sued Texaco, which resulted in the well-publicized judgment in favor of Pennzoil of some $10.5 billion. *See* Pennzoil Co. v. Texaco, Inc., No. 84-05905 (D. Harris Cty., Feb. 21, 1986); Gelfand, *"Puns Oil Sues Toxico": A Comedy of Errors in (at Least) Four Acts*, 11 DEL. J. CORP. L. 345 (1986).

56. *Polk*, 507 A.2d at 533.

57. *Id.* at 534.

Texaco board directed.[58] This provision was later amended to remove the Texaco board's control of the vote of these shares.[59]

The court found that the board had met the enhanced duty rule of *Unocal* by showing they had reasonable grounds for believing that a danger to corporate policy existed because of the Bass group's ownership of Texaco stock. In this regard, as in the cases previously discussed, the court said that the obligation of the board to meet its burden of proof was materially enhanced by the fact that the board had a majority of outside directors. Specifically, the court said, "Here, the presence of 10 outside directors on the Texaco board, coupled with the advice rendered by the investment banker and legal counsel, constitute a *prima facie* showing of good faith and reasonable investigation."[60] The court added that with ten of the thirteen di-

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58. *Id.* As a result of this repurchase, the Bass group realized a profit of some $400 million. McCartney, *Wealth: A Family Tradition*, Sunday News J., Oct. 7, 1984, at C1, col. 1.

59. *Polk*, 507 A.2d at 535. This suit was settled on the basis of the modification of the agreement to provide that the Texaco board would not control the vote of the preferred stock held by the Bass group. In addition, Texaco agreed to make certain disclosures about the suit. As part of the settlement, Texaco paid $700,000 in attorneys fees and litigation expenses. The supreme court ruled that the trial court did not abuse its discretion in approving the settlement. *Id.* at 539.

60. *Id.* at 537. In MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985), the court noted that 6 of Revlon's 14 directors held senior management jobs. *Id.* at 1243 n.2. Four of the remaining six were associated at some point with other entities that had business relationships with Revlon. The court said that on the basis of the limited record, it could not conclude that the board was entitled to certain presumptions that generally attach to decisions of a board whose majority consists of truly outside independent directors. It is doubtful a majority of unaffiliated outside directors would have affected the court's decision. The court held that the asset lock-up option and no-shop covenants adopted by Revlon to fend off the takeover attempt of Pantry Pride were invalidly adopted because they ended an active auction for Revlon. *Id.* at 1250.

Having a majority of outside directors on the board is not always a saving factor. In Norlin Corp. v. Rooney Pace, Inc., 744 F.2d 255 (2d Cir. 1984), although there was a majority of outside directors on Norlin's board, the court invalidated stock issuances to a subsidiary and an ESOP by which the target company's directors gained control over 49% of the company's voting power. These transactions caused the New York Stock Exchange to delist Norlin's stock. The court held that the share issuance to the subsidiary was illegal under New York and Panamanian statutes. The court affirmed the trial court's specific factual finding that the ESOP had been "created solely as a tool of management self-perpetuation." *Id.* at 266.

Additionally, in Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986), the defendants argued, *inter alia*, that because the lock-up option was granted by the outside directors (the three inside directors of the 12-person board did not participate in the decision) and there was no evidence of fraud, bad faith, or self-dealing, the judgment of the board as to the lock-up option prices was

rectors independent, the plaintiffs bore a heavy burden of overcoming the presumption attaching to the board's decisions.[61]

IV. IS THERE A DIFFERENT STANDARD OF CARE FOR OUTSIDE DIRECTORS?

A. *The* Trans Union *Case*

In the controversial case of *Smith v. Van Gorkom*[62] (*Trans Union*), the majority of the Delaware Supreme Court expressed a clear concern for the possible liability of the directors of Trans Union corporation who had no knowledge of the proposed merger before the initial meeting of the board of directors when the transaction was

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subject to the business judgment rule. The court held, however, that the plaintiff established a prima facie case that the outside directors had not met their duty of care in gathering and considering material information. *Id.* at 274. Because of this and their failure to establish that the option prices were fair, the court in its remand ordered the district court to enjoin the exercise of the lock-up option. *Id.* at 283. With respect to the business judgment, the court stated: "Under the circumstances presented in this case, the business judgment doctrine is misapplied when it is extended to provide protection to corporate board members where there is an abundance of evidence strongly suggesting breach of fiduciary duty . . . ." *Id.*

Has the court, in using the term "doctrine," adopted Mr. Hinsey's concept of the business judgment doctrine? *See infra* note 178.

61. *Polk*, 507 A.2d at 537. Professor Coffee has suggested that one of the reasons the pattern of litigation has shifted in defendants' favor is because "the shift toward 'independent' boards of directors may have convinced the courts that there is less justification to rely on shareholder litigation as a monitoring device. Corporate governance, it can be argued, has improved, and thus needs less judicial oversight." Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 7 (1985).

62. 488 A.2d 858 (Del. 1985). There was a companion case in the Federal District Court for the Northern District of Illinois, Ridings v. Canadian Imperial Bank of Commerce Trust Co. (Bahamas) Ltd., 94 F.R.D. 147 (N.D. Ill. 1982). This case was included in the settlement of *Trans Union*.

As to the controversial nature of the opinion, Bayless Manning, in an article in the *Business Lawyer*, stated: "The corporate bar generally views the decision as atrocious." Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985) [hereinafter Manning, *Reflections*]. Professor Fischel stated that *Van Gorkom* was "one of the worst decisions in the history of corporate law." Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985).

Others, however, have not agreed with these critics. For example, two commentators in a recent article disagreed with Professor Fischel's claim that the decision in *Trans Union* constituted "bad law" or that the rule announced is contrary to the interests of stockholders. Schwartz & Wiles, Trans Union: *Neither "New" Law Nor "Bad" Law*, 10 DEL. J. CORP. L. 429, 431 (1985). William Prickett, counsel for the plaintiffs, stated: "[T]he assertions that *Trans Union* is either a radical

first approved. Five of the ten directors were outsiders and independent.[63]

The court noted that questions of whether one or more of the directors should be treated separately in invoking the business judgment rule and in applying section 141(e) of the DGCL were not addressed by the parties in their original briefs.[64] This resulted in supplemental briefs and a second rehearing *en banc* on two questions:

> (a) [W]hether one or more of the directors were deprived of the protection of the business judgment rule by evidence of an absence of good faith; and
> (b) [W]hether one or more of the outside directors were entitled to invoke the protection of 8 *Del. C.* § 141(e) by evidence of a reasonable, good faith reliance on "reports," including legal advice, rendered the Board by certain inside directors and the Board's special counsel, Brennan.[65]

Further, during the original argument there was the following colloquy between Justice Moore and counsel for the defendants:

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decision or in any way changes the law of Delaware so far as the business judgment rule and its presumptions are concerned is simply incorrect." Prickett, *An Explanation of* Trans Union *to "Henny-Penny" and Her Friends*, 10 DEL. J. CORP. L. 451, 460 (1985) [hereinafter Prickett, *Henny-Penny*]. Mr. Prickett further observed that the "decision in *Trans Union* was the only justifiable result in the light of: (1) the egregious record of repeated instances of gross negligence by the Trans Union Board, and (2) the existing Delaware law." *Id.* at 462.

63. The outside directors and their experiences or occupations were as follows: Dr. A.W. Wallis, professor of Economics at Yale University, dean of the Graduate School of Business at the University of Chicago, chancellor of the University of Rochester, and a director of several other companies; William B. Johnson, chairman and chief executive officer of I.C. Industries Holding Company; Joseph Lanterman, a C.P.A., and president and chief executive officer of American Steel and director of several other companies; Graham Morgan, former chairman and chief executive officer of U.S. Gypsum; Robert Reneker, former president and chief executive officer of Swift and Company, and a director of several other companies. *Trans Union*, 488 A.2d at 894 (McNeilly, J., dissenting).

64. *Id.* at 888.

65. *Id.* at 888-89. Mr. Brennan, outside counsel, informed the directors at the September 20 meeting that they would probably be sued if they did not accept Pritzker's offer. *Id.* at 868. There was testimony that Brennan advised the board that Delaware law did not require a fairness opinion or an outside valuation of the company before the board could act on the Pritzker proposal. The court observed that, if given, the advice was correct. However, the court further said that such advice is meaningless unless the directors have before them adequate information regarding the intrinsic value of the company upon which a proper exercise of business judgment could be made. *Id.* at 881. Counsel Brennan is the mystery man of this litigation for, despite his early advice to Trans Union, he did not appear or testify at the trial. *Id.* at 880.

> Justice Moore: Is there a distinction between Chelberg and Van Gorkom [inside directors] and the other defendants? [the three other inside directors and the five outside directors]
> Counsel: No, sir.
> Justice Moore: None whatsoever?
> Counsel: I think not.[66]

With respect to a possible distinction, the court concluded:

> (1) . . . [S]ince all of the defendant directors, outside as well as inside, take a unified position, we are required to treat all of the directors as one as to whether they are entitled to the protection of the business judgment rule; and (2) that considerations of good faith, including the presumption that the directors acted in good faith, are irrelevant in determining the threshold issue of whether the directors as a Board exercised an informed business judgment.[67]

Would the court have reached a different conclusion as to the outside directors and the three inside directors not privy to Van Gorkom's merger negotiations if counsel had argued for it?[68] One can only

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66. Transcript of Argument in Delaware Supreme Court at 49, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). After saying, "I think not," Mr. Payson, counsel for defendant, stated:

> Mr. Van Gorkom, after he met with Mr. Pritzker on Saturday, September 13, advised Mr. Chelberg about the discussions, went to New York to discuss with Pritzker some financial information on the company, but they had no special knowledge—they, Van Gorkom and Chelberg, had no special knowledge beyond that of the other directors except that Pritzker was looking at the company. It wasn't until the night before the special meeting [the first board meeting on September 20, 1983, at which the merger of Trans Union with an affiliate of the Marmon Group, Inc., a Pritzker holding company, was approved] that there was an offer made, so that there was nothing that the directors should have been advised about prior to the coming of the offer.

Id.

67. *Trans Union*, 488 A.2d at 889.

68. In this regard, Professor Robert Hamilton asks the question:

> Why did the defendants' lawyers in *Van Gorkom* [*Trans Union*] adopt "an all for one and one for all" approach? Assuming there was negligence is it not clear that some of the directors might have had a defense that would not have been available to Van Gorkom himself and possibly other inside directors?

HAMILTON, *supra* note 13, at 678.

speculate why counsel for defendants chose not to establish a separate defense, particularly for the outside directors. Perhaps this course was chosen in the belief that Van Gorkom and Chelberg would be the beneficiaries of a favorable holding for the other directors.

Even so, is there any ground for distinguishing the directors other than Van Gorkom and Chelberg? The facts as found by the court make it unlikely. A brief review of these facts is useful before speculating on how the outside directors would have fared if they had decided not to rise and fall with Van Gorkom and Chelberg. Jerome W. Van Gorkom, Trans Union's president and chief executive officer, owned 75,000 shares of Trans Union and was nearing Trans Union's mandatory retirement age of sixty-five.[69] He decided to sell the company and, to that end, met with Jay A. Pritzker, a well-known corporate takeover specialist.[70] After several meetings, Pritzker agreed to a $55 per share price[71] and established a deadline for Trans Union board approval. The board approved the merger at a meeting called on one day's notice to meet Pritzker's deadline. At that meeting, the directors relied on a twenty minute oral presentation by Trans Union's chairman for their approval of the merger. They were not given copies of the merger agreement or any documents summarizing the terms of the merger or supporting the adequacy of the price per share.[72] The meeting lasted about two hours.[73]

The court found that the directors were not entitled to the protection of the business judgment rule for their approval of the merger at this meeting because they were uninformed as to (1) Van Gorkom's role in forcing the sale of the company and in establishing a per share purchase price, and (2) the intrinsic value of the company. Further, the court found that, given these circumstances, at a minimum the directors were grossly negligent in approving the "sale" of the company upon two hours consideration without prior notice or the existence of a crisis or emergency.[74] It then concluded that "considerations of good faith, including the presumption that the

69. *Trans Union*, 488 A.2d at 865.

70. *Id.*

71. The market price for Trans Union stock at that time was $37.25 per share. *Id.* at 867. The $55 price represented a premium of 48% over the last closing price. *Id.* at 869 n.9.

72. *Id.* at 868.

73. *Id.* at 869.

74. *Id.* at 874.

directors acted in good faith, are irrelevant in determining the threshold issue of whether the directors as a Board exercised an informed business judgment."[75]

The Trans Union board attempted at two subsequent meetings to cure the deficiencies of the first meeting. The court agreed with the principle that a decision by an originally uninformed board may be corrected, but held that the evidence did not support the defendants' contention that the board had remedied the defects of the first meeting.[76]

In addition, the defendants relied "on the stockholder vote of February 10 for exoneration."[77] The court found, however, that such reliance was misplaced because the director defendants breached their duty of candor by their failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval.[78]

Do the facts of *Trans Union* warrant absolving the directors other than Van Gorkom and Chelberg of responsibility? A case in point on this issue is the 1962 Delaware Supreme Court decision in *Bennett v. Propp*.[79] In this case, the chairman of Noma Lite, Inc., with the knowledge of only one other director, acquired over one-fourth of the publicly held shares of his company within a short period when the company was threatened with a takeover.

The court found that the chairman's sudden decision to buy 200,000 shares of stock was not only unauthorized but also unjustified.[80] It concluded that the chairman's act was improper because

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75. *Id.* at 889. Relative to this, the court said that the defendants mistook the business judgment rule's application to the case by erroneously invoking presumptions of good faith and "wide discretion." *Id.* The defendants argued that the business judgment rule allowed the directors wide discretion in the matter of valuation and afforded room for honest differences of opinion. The court further said that since the plaintiffs did not claim, and the trial court did not decide, that $55 was a grossly inadequate price, honest exercise of business judgment was irrelevant to the threshold question of whether an informed judgment was reached. Honesty or good faith would be relevant only if there was proof offered that the sale price was grossly inadequate. *Id.* This raises the question of whether good faith has anything to do with due care and if it is a consideration only as to a violation of the duty of loyalty.

76. *Id.* at 889.

77. *Id.*

78. *Id.* at 893. *See also* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944-45 (Del. 1985) (definitive Delaware case on the disclosure requirement).

79. 187 A.2d 405 (Del. 1962).

80. *Id.* at 409.

the purchases were made primarily to preserve the control of the corporation in himself and his fellow directors.[81]

After these urgent purchases, the chairman had to deal with the problem of paying for them. The lending institutions from whom he sought to borrow the necessary funds would not come to his aid. At the time the company's assets were insufficient collateral to support a loan.[82] The company was then faced with a crisis, for if it did not have sufficient cash to pay the brokers within a short time, they would sell the shares held as collateral for the chairman's purchases at any offered price. And it was likely that the company would be held responsible for any losses.[83]

After the bank refusals, the chairman called a special meeting of the board of directors. During the meeting, arrangements were made with a factor for a loan at a high interest rate against Noma's accounts receivable to raise the funds to pay the brokers. The directors also ratified the purchases of the stock by the chairman.[84]

A stockholder sued all the directors on behalf of the corporation charging waste of corporate assets for expenditures of corporate funds to buy stock to preserve control and for payment of excessive interest on the loan to finance the purchases.[85] The trial court found that the purchases by the chairman were made primarily to preserve control and that the directors ratified the chairman's hasty action without giving any consideration to other possible means of resolving the situation.[86] All the directors appealed.

The Delaware Supreme Court held the chairman liable because the board resolution to ratify the chairman's purchases was ineffective to legalize his actions. Moreover, it held that the president was responsible to the company because he did not take steps to make some arrangements beneficial to the company. "He did nothing."[87]

The court, however, exonerated the other directors. But it was careful to note that the exception to the general rule that directors who use corporate funds to preserve control commit a wrong depends on two circumstances: (1) prior ignorance, and (2) an immediate emergency.[88]

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81. *Id.* at 408.
82. *Id.* at 407.
83. *Id.* at 408.
84. *Id.* at 407.
85. *Id.* at 408.
86. *Id.*
87. *Id.* at 411.
88. *Id.*

It is at once apparent that the outside directors in *Trans Union* could not rely on *Bennett* to exonerate themselves because the court specifically found all of the directors "grossly negligent in approving the 'sale' of the Company upon two hours consideration, without prior notice, and *without the exigency of a crisis or emergency*."[89]

The defendants in *Trans Union* argued in their brief that while there may not have been a "corporate emergency, because of the Pritzkers' deadline, the stockholders stood to lose more than $200 million (the difference between the Pritzker offer and the premerger market price) if the directors had not acted upon the offer."[90] The directors believed that the Pritzker offer would be withdrawn if they did not approve it and outside counsel advised them that they might be sued if they failed to accept the offer.[91] Obviously, the court was not persuaded by this argument.

The court also did not agree with the defendants' contention on the question of whether one or more of the outside directors were entitled to invoke the protection of section 141(e) of the DGCL by "evidence of a reasonable, good faith reliance on reports."[92] Citing *Cheff v. Mathes*, the defendants argued that the term "report" had been liberally construed to include reports of informal personal investigations.[93] The court nevertheless found that neither Van Gorkom's oral presentation of his understanding of the terms of the proposed merger nor the chief financial officer's brief statement of his study on a leveraged buy-out of Trans Union qualified as a report within the meaning of section 141(e).[94]

The court also found that the outside directors had no rational basis for concluding that the board's acceptance of Pritzker's offer was conditioned on the understanding that if there was a higher offer Trans Union could accept it. Moreover, neither the fact that Pritzker's offer was at a price that was forty-eight percent over the last closing price for Trans Union stock nor the advice of counsel at the September 20 meeting that they would be sued if they failed to accept Pritzker's offer helped the cause of the outside directors.[95]

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89. *Trans Union*, 488 A.2d at 874 (emphasis added).

90. Appellees' Reply Supplemental Brief in Delaware Supreme Court at 15, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (copy available at Delaware Law School Law Review Office).

91. *Trans Union*, 488 A.2d at 868.

92. *Id.*

93. 199 A.2d 548, 556 (Del. 1964).

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

95. *Id.* at 868, 869 n.9, 876, 879, & 880. With respect to price, the court stated

In sum, the board, including the outside directors, acted upon inadequate information at the September 20 meeting. Neither their actions at subsequent board meetings nor the stockholder approval cured the original flawed decision.[96] Thus, there is no basis in the opinion for distinguishing between the outside directors and Van Gorkom and Chelberg.

B. *Is There any Basis for a Different Standard for the Outside Directors?*

Regardless of the conclusion that the facts in *Trans Union* did not warrant excusing the outside directors, the question remains whether in other circumstances a court might conclude that a different standard should apply to such directors. That it may is implicit in the question certified to counsel for the second rehearing: whether one or more of the outside directors may be entitled to invoke the protection of section 141(e) of the DGCL by evidence of a reasonable, good faith reliance on reports including legal advice given the Board by certain inside directors [Van Gorkom and Chelberg] and the Board's special counsel. Further, as above noted, at the original argument the court asked defendants' counsel if there was a basis for any distinction between Van Gorkom and Chelberg and the other directors.[97] The outside directors should have a stronger defense in

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in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), that "in a non-fraudulent transaction [such as *Trans Union*] we recognize that price may be the preponderant consideration outweighing other features of the merger." *Id.* at 711. Obviously, the court did not recognize price to be preponderant in *Trans Union* in light of the negligence of Trans Union's directors.

96. *Trans Union*, 488 A.2d at 874, 880, 881, 884, 888, & 893. In Rowen v. Le Mars Mut. Ins. Co. v. Iowa, 282 N.W.2d 639 (Iowa 1979), the policy holders of one insurance company sued, *inter alia*, officers and directors of the Le Mars Mutual Insurance Company. The plaintiffs alleged that the directors were liable for the improper sale of control of the company. The inside directors were found responsible, but the court concluded that the four outside directors were not liable. The court said, "[A]n outside director does not have the same duty or responsibility that falls upon those who are in active charge and who dictate day-to-day policy." *Id.* at 652. The Iowa Supreme Court agreed with the trial court's finding that the facts were not disclosed to the outside directors and therefore they could not have actively participated in the plan to take over Le Mars. The court found, moreover, that these outside directors had not neglected their duties to the company. *Id.* at 653. The outside directors in *Trans Union*, however, participated in the decision to sell the company.

Trans Union was settled by payment of $23.5 million to the plaintiff class. The D&O insurer paid $10 million of this amount, which was the policy limit. The Pritzker group which acquired Trans Union is reported to have paid the bulk of the remaining $13.5 million. Manning, *Reflections*, *supra* note 62, at 1.

97. *Trans Union*, 488 A.2d at 888-89, 899.

relying on a report, for example, by a company employee, an officer, or the independent public accountants than the inside directors.[98] The inside director, as an officer of the corporation, is in daily contact with its finances and operations and therefore is in a far better position than the outside director to correct any defects in such reports.

If for some reason the directors act in reliance on a defective report which results in a loss and litigation, the outside directors should be entitled to more protection than the inside or officer directors. The right of the officer-director to rely on the information in the report should be more limited than that of the outside director because of the "greater obligation of the inside director to be familiar with the affairs of the corporation."[99]

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98. Section 141(e) of the DGCL provides as follows with respect to reports:

> (e) A member of the board of directors of any corporation organized under this chapter, or a member of any committee designated by the board of directors shall, in the performance of his duties, be fully protected in relying in good faith upon the books of account or reports made to the corporation by any of its officers, or by an independent certified public accountant, or by an appraiser selected with reasonable care by the board of directors or by any such committee, or in relying in good faith upon other records of the corporation.

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

The Revised Model Business Corporation Act standard for reliance on reports is set forth in § 8.30.

> 8.30. General Standards for Directors
>
> (b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
>
> (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
>
> (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
>
> (3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.
>
> (c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

2 REVISED MODEL BUSINESS CORP. ACT § 8.30, Official Comment (1985) [hereinafter RMBCA]. A Delaware court has held that § 141(e) fully protects directors of a corporation where they rely in good faith on books of account and reports made by any of its officials, or by an independent certified public accountant. Prince v. Bensinger, 244 A.2d 89, 94 (Del. Ch. 1968).

99. ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.02 (Tent. Draft No. 4, 1985) [hereinafter ALI Draft No. 4]. See also

There are, of course, certain conditions applicable to the outside director's reliance on reports. As noted elsewhere in this article,[100] a report is not entitled to the benefit of section 141(e) of the DGCL unless it is: (1) pertinent to the subject matter being considered, and (2) entitled to good faith, not blind reliance.[101] Certainly this means that the director must have read the report and have no information to cause him to question its accuracy.

Thus, to the extent that outside directors have a more limited duty than inside directors in relying in good faith on section 141(e) type reports, there is a different standard between inside and outside directors.[102]

In addition, the inside directors have a greater obligation than the outside directors in oversight and decision-making functions. In *Aronson v. Lewis*,[103] the court said that the directors have a duty to inform themselves of all material information reasonably available before making a decision and that they must act with requisite care in the discharge of their duties.[104] There is no hint in *Aronson* of a distinction between the responsibility of inside and outside directors; apparently they are all subject to the same standard.

ALI FEDERAL SECURITIES CODE § 1704, at 712 (1980), wherein it is stated: "[A]n outside director, for example, should be able more readily than an officer or underwriter to rely on officers and other competent employees for information concerning the business." *See also* RMBCA, *supra* note 98, § 8.42.

100. *See infra* notes 139-145 and accompanying text.

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

102. Graham v. Allis Chalmers, 188 A.2d 125, 130 (Del. 1963) (directors entitled to rely on summaries, reports and corporate records in making broad policy decisions); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977) (directors entitled to rely on the reports of investment firms); David J. Greene & Co. v. Dunhill Int'l Inc., 249 A.2d 427, 431-32 (Del. Ch. 1968) (directors protected in relying upon certain reports made to the corporation).

103. 473 A.2d 805 (Del. 1984).

104. *Id.* at 812. One eminent lawyer has opined to me that this is not a standard of care rule. The Delaware Supreme Court apparently believes it has articulated a standard of care rule, for in *Trans Union* it stated:

> The standard of care applicable to a director's duty of care has also been recently restated by this Court. In *Aronson, supra*, we stated:
>
> While the Delaware 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. 473 A.2d at 812.
>
> We again confirm that view. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

Trans Union, 488 A.2d at 873.

But in the sense that directors are responsible only for overseeing the operation of the corporation in accordance with the wording of section 141(a) of the DGCL, that the business and affairs of the corporation "shall be managed by or under the direction of"[105] the board of directors, there is a sensible basis for applying a different standard to outside directors in a proper case. For example, assume that non-director officers of a large public company commit a fraud that causes it substantial losses. They have managed to hide their deception from the internal auditors and the independent accountants. The directors have approved the monthly reports of the audit committee and know that a procedure is in effect to detect employee fraud. The outside directors, even those on the audit committee, have no reason to believe that the officers are dishonest and nothing has come to their attention to put them on notice of a problem. The chairman, the president, and the chief financial officer serve on the board of directors with ten outside directors. The board has twelve monthly meetings each year. Are the outside directors subject to the same standard of care in this case as the inside directors?

Here, it is believed that the inside directors have a stricter duty than the outside directors. There is no reason to assume that the outside directors violated their duty of attention; thus, they were not negligent in the failure to prevent or discover the fraud. On the other hand, the inside directors who were in daily contact with the employee officers in question should have a higher duty than the outside directors to prevent or discover the employee defalcation. As stated by the court in *Rowen v. Le Mars Mutual Insurance Co. of Iowa*,[106] "an outside director does not have the same duty or responsibility that falls upon those who are in active charge and who dictate day-to-day policy."[107]

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105. DEL. CODE ANN. tit. 8, § 141(a) (1983).

106. 282 N.W.2d 639 (Iowa 1979).

107. *Id.* at 652. As discussed *supra* note 96, the court absolved the outside directors in the sale of control of the insurance company. The inside directors did not disclose the facts to the outside directors, and they did not participate in the transaction. The record showed they had confidence in the judgment of the management director. *Id.* at 653. In Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), a tender offer case in which the plaintiffs alleged they were damaged by material omissions from the registration statement, the court stated as follows with respect to the respective duties of outside and inside directors: "Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the registration statements than outside directors." *Id.* at 578.

Admittedly it is risky to generalize. The degree of care or the alleged negligence of the outside directors must be considered in each case. In this respect attention must be given "to the nature of the business, its size, the extent, method and reasonableness of delegation of executive authority, and the existence or non-existence of zeal and honesty of purpose in the directors' performance of their duties."[108]

Two scholars have expressed the view that outside directors who serve on certain board committees assume more responsibility for the affairs of the corporation than those who have no committee assignments. Specifically, they said:

> For example, the modern outside director who serves on an audit committee and has reasonable access to extensive information and sophisticated independent professional assistance and who nevertheless fails to monitor management, may well be found to have breached his common law duty of care.[109]

It is doubtful, however, that a director member of the audit committee which meets three or four times a year[110] and periodically receives reports from the public accountants should have the same degree of responsibility for the company's business and affairs as the directors who are also the chief executive, the chief operating, or the chief financial officers.

In Hamilton Bank & Trust Co. v. Holliday, 469 F. Supp. 1229 (N.D. Ga. 1979), the plaintiff alleged the defendant violated federal and state securities laws and committed fraud in the sale of a participating interest in a pool of loans. The outside directors of the company whose subsidiary made the sale of the securities in question were included among the defendants. The court said:

> [I]t is unrealistic to require outside directors of a corporation—i.e., those who are not full-time employees of the corporation—to investigate the corporation's incidental securities transactions carried on by or participated in by the corporate officers without the directors' actual knowledge or participation.

Id. at 1242. *See* Francis v. United Jersey Bank, 87 N.J. 15, 41- 45, 432 A.2d 814, 827-29 (1981) (outside director liable to creditors because of her failure to read and understand the financial statements of a closely held insurance brokerage company and to make reasonable attempts to detect and prevent the conversion of trust funds by her officer sons).

108. Graham v. Allis Chalmers Mfg. Co., 182 A.2d 328, 332 (Del. Ch. 1962), *aff'd*, 188 A.2d 125 (Del. 1963).

109. Hahn & Manzoni, *Duty*, *supra* note 22, at 615.

110. KORN/FERRY, *supra* note 1, at 15. The Korn/Ferry survey of over 550 companies shows that the audit committees of those companies met an average of three times each in the years 1984 and 1985. *Id.*

However, in decisions on basic corporate changes such as charter amendments, leveraged buyouts, mergers, issuance of shares and takeover actions, outside directors are especially vulnerable to litigation. As to such extraordinary corporate matters, one prominent commentator advises that directors—outside and inside—should be "more than usually alert, deliberative, focused, prepared, counseled, paper-tracked, and generally professional in their behavior."[111] He characterizes these basic corporate transactions as embracing ownership issues because they directly affect the shareholder's stock and, therefore, should be distinguished from enterprise decisions such as the approval of building a plant. As to the latter, he opines that "directors will find that they will have little to fear from judicial Monday morning quarterbacking."[112]

It is certainly true that as to matters related to basic corporate changes or shareholder ownership, the outside directors are more exposed to lawsuits and liability than in enterprise matters. Therefore, as to ownership issues the outside directors are well advised to follow the teaching of *Trans Union* and insist that before acting they have relevant material information, including a written report from management summarizing the transaction and the advice of counsel and investment advisers. Moreover, the valuation of any shares in the transaction should be determined by "techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court . . . ."[113]

The court in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,[114] in which the court enjoined the exercise of a lock-up option, provides useful guidance as to the duty of outside directors in an ownership transaction. The court noted that all directors have the duty to make

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111. Manning, *Reflections, supra* note 62, at 6. Manning later commented that there is a third type of issue facing boards—the regulatory regimen the external public environment imposes on boards. An example is society's environmental concerns. DIRECTOR ROUNDTABLE: THE D&O CRISIS AND BOARD LIABILITY, DIRECTORS AND BOARDS 13 (Summer 1986).

112. Manning, *Reflections, supra* note 62, at 6.

113. Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983). For an excellent discussion on the responsibility of directors in tender offers, see AMERICAN BAR ASSOCIATION GUIDELINES FOR DIRECTORS: PLANNING FOR AND RESPONDING TO UNSOLICITED TENDER OFFERS, SECTION OF CORPORATION, BANKING AND BUSINESS LAW (rev. ed. Dec. 1985).

114. 781 F.2d 264 (2d Cir. 1986). In this case a lock-up option for certain corporate assets of SCM Corporation was granted to a third party in a management-participation leveraged buyout of SCM Corporation. The LBO arrangement was entered into as an antitakeover measure.

decisions likely to affect shareholder welfare on the basis of "reasonable diligence."[115] Further, although the outside directors in that case did not breach their duty of loyalty, they had not "pursued adequately their obligation to ensure the shareholder's fundamental right to make the 'decisions affecting [the] corporation's ultimate destiny' as required by their duty of care."[116] The concurring judge in *Hanson* assigned to the outside directors the duty to be "fully informed" and stated that if they rely on advisers, to make certain the advisers are fully informed and that, in turn, the advisers fully inform the outside director.[117]

Thus, as to basic corporate ownership transactions, particularly in tender offer contests, it is unlikely that a court would apply a different standard to the outside directors. Although the management director is in a better position to know the relevant facts about whether, for example, an antitakeover action or a merger is in the best interest of the corporation and its stockholders, the court probably would not hold the outside directors to a lesser standard in being informed and in exercising requisite care in their decisions.

V. PROTECTION FROM LIABILITY FOR OUTSIDE DIRECTORS

Although much of the following discussion applies to both inside and outside directors, my purpose is to focus on the protection from liability for the outside director.

A. *Informed Decision Making and Responsible Oversight*

If outside directors conscientiously inform themselves of all related material facts before making decisions and if they actively oversee the conduct and operations of the corporation, the risk of being charged with a violation of a fiduciary duty will be significantly reduced. Their duties include the responsibilities to review and confirm basic corporate objectives and to require that policies and procedures are in place to promote compliance with laws and regulations by all levels of management.

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115. *Id.* at 274.

116. *Id.* at 276-77.

117. *Id.* at 284. Two lawyers specializing in corporation law recently wrote that as to corporate control transactions, "it is clear that virtually every court is exhibiting an increased concern with a board's fiduciary duty of care in the corporate control setting." Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 38 (1986) [hereinafter Wander & LeCoque, *Jitters*].

1. Informed Decision Making

The standard for informed decision making was established by the Delaware Supreme Court in *Aronson v. Lewis*,[118]in which the court restated Delaware's business judgment rule and its limitations. According to the court, the directors have a duty to inform themselves of all material information reasonably available to them before making a business decision and, after so arming themselves, act with requisite care. The informational requirement of *Aronson* certainly includes a director's duty to attend board and committee meetings. In addition, outside directors should insist that management establish a system to ensure that they have sufficient information to fulfill their responsibilities. This means that relevant material information about any action proposed to be taken at a board meeting should be furnished to the directors in time sufficient to review it.

If such a system had been in place and followed, the uninformed decision making problems of *Trans Union* would have been avoided. The *Trans Union* court pointed out that at the first board meeting where the sale of the company was approved, the directors:

(1) had no documents before them concerning the proposed transaction,

(2) were required to rely entirely upon the chairman's 20- minute oral presentation of the proposal,

(3) received no written summary of the terms of the merger,

(4) were given no documentation to support the adequacy of the price per share for sale of the company, and

(5) had before them nothing more than the chairman's statement of his understanding of the substance of the agreement which he admittedly had never read, nor any member of the board had ever seen.[119]

Because of these facts and the court's finding that there was no crisis or emergency, the court concluded that the directors allowed themselves to be "stampeded into a patently unadvised act" and were "grossly negligent" in approving the sale of Trans Union.[120]

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118. 473 A.2d 805, 812 (Del. 1984). *Aronson* is also a significant decision because it answered the question left unresolved in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) of when the requirement of a stockholder's demand upon a board of directors to redress an alleged wrong is excused as futile. The court held that demand can only be excused where facts are alleged "with particularity which, taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment . . . ." *Aronson*, 473 A.2d at 815. *See* Pease, *Business Judgment Rule*, *supra* note 28.

119. *Trans Union*, 488 A.2d at 874.

120. *Id.*

In *Household International*, the Delaware Supreme Court provided a guide for the sort of information that would pass the test. After a review of the evidence, the court found that the directors of Household were not "grossly negligent" as to their duty to inform themselves. The court further said that the information supplied to the directors provided the essentials of the preferred stock rights plan. The information included:

1. A three page summary of the Plan along with articles on the then current takeover environment.

2. Extended discussion between the board and an outside law firm specializing in advising in takeovers which reflected a full and candid evaluation of the plan, and

3. The dissenting views of a director opposed to the plan that served to place before the board a knowledgeable critique of the plan.[121] The court said that the board's consideration of this information distinguished *Household International* from *Trans Union*.

Aronson's standard on information necessary for board decision-making is that directors consider all material matter reasonably available. At times the board must act in emergencies when there is simply not enough time to supply all relevant "material" information to board members before a decision-making meeting.[122] This is particularly true in the crises of tender offers and takeovers where crucial decisions often must be made without complete information.

What guidelines may be given to a board if it is acting in a genuine crisis? In this situation, directors will have to rely on the

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121. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985). Additionally, in Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985), the court found that both the Getty and Skelly boards took their actions approving a merger on an informed basis. The directors were fully briefed by their investment advisors, copies of the proxy statement had been given to the Skelly directors prior to their meetings, Skelly's directors had been given a legal opinion on the merger, the directors had heard from attorneys representing stockholders who were threatening suit, and there was a thorough discussion of the proposed merger before approval was given. *Id.* at 939. *See also* Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980), *rehearing and rehearing en banc denied* (1980).

Furthermore, in *Treadway* the court approved the action of a New Jersey corporation in issuing additional shares which were purchased by a friendly corporation, based on the business judgment of the board that acquisition of control by another corporation would not be in the best interest of the corporation. The court found that the directors were informed in taking their action because the directors (1) "armed" their bankers with financial questions to evaluate, (2) requested balance sheets, (3) adjourned deliberations for one week to consider the requested information, and (4) conditioned appproval of the transaction on securing a fairness opinion from their bankers. *Id.* at 384.

122. *See* Pease, *Business Judgment Rule, supra* note 28, at 66-68, 82-84.

presentation and recommendation made to the board by the chief executive officer, his staff, and outside experts. As I stated in another article:

> [D]irectors should be protected by the [business judgment] rule in those situations where prompt action is required if they rely primarily, if not completely, upon presentations and recommendations of management, other directors, employees and experts in whom they have confidence. In addition, their decision should be made in the good faith belief that it is in the best interests of the company.[123]

The *Guidebook*'s standard supplies an important condition to that statement: "The corporate director should feel that he is sufficiently informed so that he can explain a vote for or against."[124] It should be noted that the Delaware Supreme Court exonerated the directors, other than the chairman and the president, in *Bennett v. Propp* because of the immediate emergency confronting them. The court held that the pressure of time justified their action to save the company.[125]

The ALI points out that some business decisions must be made under severe pressures, while others afford time for the orderly marshalling of material information. Further, it notes that the

> time realistically available may compel risk taking, which includes the risk of not having all relevant facts concerning a proposed transaction as well as the risks related to the economic consequences of the transaction itself. A decision to accept the risk of incomplete information, so long as the director reasonably believes such informational risk taking to be appropriate under the circumstances will be fully consistent with the application of the business judgment rule to decisions made with respect to the principal transaction.[126]

2. Oversight

In addition to acting upon matters brought to the meeting by management, the outside directors must also keep informed about

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123. *Id.* at 66. Under Rule 14e-2, the target management has only 10 days from the date the tender offer is first published to provide its security holders with its position on the merits of the offer. 17 C.F.R. § 240.14e-2 (1986).

124. *Guidebook*, *supra* note 8, at 1609.

125. *Bennett*, 187 A.2d at 410.

126. ALI Draft No. 4, *supra* note 99, § 4.01(c).

the conduct and operation of the company's business. As to this oversight obligation, the *Guidebook* furnishes a useful list of information that periodically should be disclosed to directors.

(a) meaningful financial statements,

(b) periodic reporting on various areas of compliance and material litigation,

(c) periodic briefing by senior executives relative to developments affecting the business and affairs of the enterprise, and

(d) reports on forward planning.

Further, the adequacy of the information should be reviewed from time to time, perhaps by the audit committee.[127]

The court in *Joy v. North*[128] provided a perspective on the directors' oversight duty. In that case the defendant directors were charged, *inter alia*, with violation of a fiduciary duty by authorizing and defending loans. A special litigation committee recommended that the suit be discontinued as to the outside directors because there was no reasonable possibility that they might be found liable since they had no knowledge of the loans. The court of appeals disagreed, stating that lack of knowledge is not necessarily a defense if it is the result of abdication of directorial responsibility. The court said:

> Directors who willingly allow others to make major decisions affecting the future of the corporation wholly without supervision or oversight may not defend on their lack of knowledge, for that ignorance itself is a breach of a fiduciary duty. The issue turns in large part upon how and why these defendants were left in the dark.[129]

However, the court then noted that an individual analysis may show that some of the outside directors were blameless or that they had an excuse for not acting sooner.[130] The court of appeals remanded these questions to the trial court for determination.

The *Joy* court cited the Delaware case of *Graham v. Allis Chalmers*

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127. *Guidebook*, *supra* note 8, at 1608-09.

128. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

129. *Id.* at 896.

130. *Id.* A recent New York Times article described a complaint in a case involving the directors of Allegheny International in which the complaint alleged the directors had violated their oversight duties in permitting waste of corporate assets by allowing the company to maintain five jet airplanes, lend $32.3 million to employees at low interest rates and employ sons and daughters of union executives on the payroll. Conlin, *Allegheny International's Chief Quits*, N.Y. Times, Aug. 9, 1986, at 29, 31, col. 3.

Manufacturing Co.[131]for its position on the oversight function. In *Graham*, the plaintiffs contended that the directors were liable for failing to discover and prevent antitrust violations by employees of Allis Chalmers. The plaintiffs argued that the directors had a duty to monitor the employees' law compliance program because a consent decree entered into some twenty years before should have put them on notice that employees could be in violation of the antitrust laws. The court did not agree and, as to the oversight function, said that directors are bound to use that degree of "care which ordinarily careful and prudent men would use in similar circumstances."[132] Further, a director will be liable 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 . . . ."[133] The *Graham* court also said:

> [A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists . . . . [W]e know of no rule of law which requires a corporate director to assume . . . that all corporate employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities.[134]

This case has been criticized because it seemed to approve a passive role for the board of directors.[135] This evaluation is not

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131. 188 A.2d 125 (Del. 1963).

132. *Id.* at 130.

133. *Id.*

134. *Id.* at 130-31.

135. *See* ALI Draft No. 4, *supra* note 99, § 4.01(a)(1)-.01(a)(2). At its May 17, 1985 meeting, the ALI amended its earlier stand on the duty of inquiry. It stated that the duty of care:

> includes the obligation to make or cause to be made an inquiry when, and only when, the circumstances would alert a reasonable director or officer of the need therefore. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.

ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 401(a) (Tent. Draft No. 4, amended May 17, 1985) [hereinafter ALI Amended Draft No. 4].

As to a law compliance program, the Corporate Director *Guidebook* states:

> The corporate director should be concerned that the corporation has programs looking toward compliance with applicable laws and regulations,

justified. The directors were supplied with financial and operating data relating to all phases of the company's activities. At board meetings, company policies were considered and decided in reliance on summaries, reports, and corporate records. The board meetings were of several hours' duration and all the directors participated actively in the meetings.[136] Moreover, when put on notice that employees may have been violating the law, the board promptly directed that a policy statement relating to antitrust problems be published to all employees whose activities could have antitrust implications.[137] The court concluded that until directors have notice of facts to alert them to take steps to prevent future violations, they "are entitled to rely on the honesty and integrity of their subordinates."[138] This "red flag" test of *Graham* is still the law of Delaware.[139]

> both foreign and domestic, that it circulates (as appropriate) policy statements to this effect to its employees, and that it maintains procedures for monitoring such compliance.

Guidebook, *supra* note 8, at 1610. *See also* Lutz v. Boas, 171 A.2d 381, 395-96 (Del. Ch. 1961) (chancery court held directors of a mutual fund liable because the defendant-directors gave almost "automatic approval" to transactions and gave scant attention to the affairs of the business).

In Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981), the estate of a director was held responsible for certain unlawful payments. The court's opinion included the statement that a director is expected to maintain familiarity with the financial status of the company by a regular review of the financial statements. *Id.* at 32, 432 A.2d at 822. The court concluded that the defendant director's inattention to her duties was the proximate cause of the loss incurred. *Id.* at 44, 432 A.2d at 829.

136. *See Graham*, 188 A.2d at 128.

137. *Id.* at 128-29.

138. *Id.* at 130.

139. *See* Veasey, *Directors and Officers*, in I. BALOTTI & J. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUS. ORGANIZATIONS 120 (1980) [hereinafter Veasey, *Directors*].

The liability of directors under the federal securities laws is outside the scope of this article. Nevertheless, attention should be called to the fact that these laws require a high degree of inquiry. A commentator in this area has written:

> Increasingly, outside directors find themselves on the horns of a dilemma. On the other hand, federal securities laws have significantly expanded their liability—their responsibility has been enlarged and the standard of care applied to their conduct raised. Further, the less stringent standards of state law "prudent man" or "business judgment" rules can give them little solace. What is clear is they cannot count on being protected if they merely attend board meetings and accept data supplied by management. The federal securities laws demand a standard of "due diligence" that calls for a significant degree of individual inquiry.

Caplin, *How to Protect Outside Directors Against Liability Under the Securities Laws*, 1 Corp. Guide (P-H) ¶ 26,028 (1980), *quoted in* W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 407 (5th ed. 1980).

This is illustrated by the well-known case of Escott v. Bar Chris Constr. Corp.,

Moreover, the ALI recognized this test when the language of section 4.01(a)(11) of Tentative Draft No. 4 was changed by a proposal of the Reporters during floor discussion at the May 1985 Annual Meeting of the Institute. The pertinent language reads:

> (1) This duty [of inquiry] includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.[140]

As stated by the President of the Institute, this formulation requires a "triggering" event, "and in that sense constitutes a 'red flag' test of the type that many commentators have been advocating."[141]

3. Reliance on Reports

Under section 141(e)[142] of the DGCL, members of the board may rely on reports of the officers of the corporation and others in their decision making and oversight roles. The court in *Trans Union*, however, placed important conditions on reports qualifying under that section. At a minimum, the court said the report must be pertinent to the subject matter upon which a board acts. In addition, the report must otherwise be entitled to good faith, not blind reliance. The court added that

> [c]onsidering all of the surrounding circumstances—hastily calling the meeting without prior notice of its subject matter,

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283 F. Supp. 643 (S.D.N.Y. 1968), where the registration statement contained a number of material misstatements and also omitted material facts. The court held the inside directors to the highest standard of care because they knew all of the relevant facts and could not have believed that there were no untrue statements. *Id.* at 684-85. In addition, the outside director who signed the registration statement was held liable even though he became a director on the eve of the financing and had little time to familiarize himself with the company's affairs. *Id.* at 688. The court based its holding on the failure of the director to make any investigation before signing the statement. *See* 17 C.F.R. § 230.176 (1986) (rule setting forth the factual inquiry that must be made).

140. ALI Amended Draft No. 4, *supra* note 135, § 401(a).

141. *See* Perkins, *The ALI Corporate Governance Project in Midstream*, 41 BUS. LAW. 1196, 1207 (1986) [hereinafter Perkins, *ALI*].

142. DEL. CODE ANN. tit. 8, § 141(e) (1983). *See also supra* notes 96-102 and accompanying text (respective responsibilities of inside and outside directors as to reports).

> the proposed sale of the company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever—the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans . . . .[143]

The only information before the Trans Union board at the meeting when the sale of Trans Union was approved was Van Gorkom's oral presentation of his understanding of the terms of the proposed merger agreement—a document he had not seen—and the chief financial officer's brief statement of his preliminary study regarding a leveraged buyout of Trans Union. As to the latter, no director asked for any further information from the financial officer or asked to see the study.[144] The court found that none of this information qualified as "reports" within the meaning of section 141(e).[145] But the court did say that directors may be fully protected in appropriate circumstances in relying in good faith upon the valuation reports of management.[146]

The official comment in the standard of conduct provision (section 8.30) of the RMBCA gives appropriate direction regarding reliance upon reports. A director who relies on a report must be without knowledge of the matter in question that would cause his reliance to be unwarranted. Moreover,

> in order to be entitled to rely on a report, statement, opinion, or other matter, the director must have read the report or statement in question, or have been present at a meeting at which it was orally presented, or have taken other steps to become generally familiar with its contents.[147]

4. Minutes

Board minutes can be of critical importance to outside directors

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

144. *Id.* at 877.

145. *Id.* at 875.

146. *Id.* at 876, 877. The court made this statement after noting that it did not imply that an "outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law." *Id.*

147. RMBCA, *supra* note 98, § 8.30.

in litigation.[148] In *Trans Union*, the court specifically noted that the minutes did not include any reference to the merger agreement or that an auction for the sale of Trans Union was permitted to occur.[149] It is essential, therefore, that the minutes specify the action taken and other matters considered at any meeting. Since minutes are subject to subpoena, they should be carefully written to reflect accurately the action taken and the other items on the agenda that were considered. Minutes should not include extraneous and unnecessary information. The court will presume that the minutes correctly reflect what took place at the meeting, but minutes may be supplemented by other evidence.[150]

There has been a long-standing debate about the respective merits of short-form and long-form minutes. Corporate secretaries report that the trend is toward long-form minutes for the following reasons:

1. The board of directors wants a record that reflects the information received and discussions held respecting a particular matter as an administrative check list and in order to record its due diligence;

2. Management wants a record that reflects the information provided to the board of directors concerning the status of the business and operations of the company and information presented in support of the recommendations of management; and

3. Lawyers, accountants and auditors recommend levels of detail sufficient to evidence compliance with law, good faith, due diligence and a rational basis of action which will provide a business judgment defense.[151] The principal consideration with long-form minutes is that

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148. The DGCL requires that "[o]ne of the officers shall have the duty to record the proceedings of the meetings of the stockholders and directors in a book to be kept for that purpose." DEL. CODE ANN. tit. 8, § 142(a) (1983). The Model Business Corporation Act provides that each "corporation shall 'keep' as permanent records minutes of all meetings of its shareholders and board of . . . records [may be] in written form or in another form . . . capable of conversion within a reasonable time." RMBCA, *supra* note 98, § 16.01. For a discussion of meetings of the board of directors, see generally AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC., MEETINGS OF THE BOARD OF DIRECTORS AND ITS COMMITTEES: A GUIDEBOOK(Sept. 1985) [hereinafter ASCS MEETINGS], and in particular the section on board minutes. *Id.* at 58-77.

149. *Trans Union*, 488 A.2d at 878.

150. Bennett v. Propp, 187 A.2d 405, 410 (Del. 1962).

151. ASCS MEETINGS, *supra* note 148, at 61-62. The short form style only states the action taken. None of the discussion is included in the minutes as in the longer form. The short form, however, will refer to any reports considered and such reports will be attached to the minutes. Professor Donald Schwartz, Georgetown

they should make certain that all the important points with respect to any matter are properly included.

On the other hand, the short-form style has much to recommend it. Operating under the premise that the less said the better, short-form minutes minimize the problem of making certain that all important matters are covered.

Other considerations with respect to minutes are (1) they should not correct a deficiency of the meeting, and (2) careful attention should be given to changes in style or format of the minutes. Such changes are noticeable and could result in counsel questioning the reasons for the change. Any substantive meeting deficiencies, of course, should be corrected at the next board meeting.

B. Protection of the Business Judgment Rule

The business judgment rule embodies the view that courts are ill-equipped to decide what is or is not sound business judgment.[152] The statutory basis for the rule is found in section 141(a) of the DGCL, which states that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."[153]

University Law Professor, speaking at a securities law conference on January 22, 1987 contended that the traditional bare bones minutes should be used. He said that elaborate attempts to recapture the discussion will only present a lot of ammunition to plaintiff's counsel. *Professor Challenges Trend Toward More Detailed Minutes*, 2 Corporate Counsel Weekly (BNA) 2, col. 1 (Jan. 28, 1987).

152. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

153. DEL. CODE ANN. tit. 8, § 141(a) (1983). The words "under the direction of" were added to § 141(a) in 1974. The statutory basis for the business judgment rule is noted in *Aronson*, 473 A.2d at 811; *Unocal Corp.*, 493 A.2d at 953 n.6. *See also* Quillen, Trans Union, *Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465, 490 (1985) [hereinafter Quillen, *Neutral Principles*]. Section 8.01 of the RMBCA has wording similar to § 141(a) of the DGCL. *See* RMBCA, *supra* note 98, § 8.01; DEL. CODE ANN. tit. 8, § 141(a) (1983).

The ALI in § 3.02 takes a different approach. Section 3.02 provides:

> (a) Except as otherwise provided by statute, the board of directors of a publicly held corporation should:
>
> (1) Elect, evaluate, and, where appropriate, dismiss the principal senior executives.
>
> (2) Oversee the conduct of the corporation's business with a view to evaluating, on an ongoing basis, whether the corporation's resources are being managed in a manner consistent with the principles of § 2.01 (Objective and Conduct of the Business Corporation).
>
> (3) Review and approve corporate plans and actions that the board or the principal senior executives consider major, and changes in accounting principles and practices that the board or the principal senior executives consider material.

Actions of directors are protected by the business judgment rule in the absence of disabling factors. The elements of the Delaware rule and its limitations were stated in *Aronson v. Lewis*.[154] It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.[155] The rule does not apply where the directors violate a

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(4) Perform such other functions as are prescribed by law, or assigned to the board under the standard of the corporation.

(b) Except as otherwise provided by statute or by a standard of the corporation, the board of directors of a publicly held corporation should also have power to:

(1) Make recommendations to shareholders.

(2) Initiate and adopt major corporate plans, commitments, and actions, and material changes in accounting principles and practices; instruct any committee, officer, or other employee; and review the actions of any committee, officer, or other employee.

(3) Manage the business of the corporation.

(4) Act as to all other corporate matters not requiring shareholder approval.

(c) Except as otherwise specifically provided by statute or by a standard of the corporation, and subject to the board's ultimate responsibility for oversight under §3.02(a), the board may delegate to its committees authority to perform any of its functions and exercise any of its powers.

ALI Draft No. 2, *supra* note 1, § 3.02.

The ALI comments that § 3.02

differs from the literal terms of statutory formulations of the role of the board . . . , but provides an articulation of basic functions and powers which almost certainly would be arrived at by the courts in light of the language of these statutes, read in the context of modern corporate practice. Although the statutes literally seem to require the board to either manage or direct the management of the corporation, it is widely understood that the board of publicly held corporation normally neither does nor can perform those functions in the usual sense of those terms.

Id.

154. 473 A.2d 805, 811 (Del. 1984). Earlier statements of the rule are in Bodell v. General Gas & Elec. Corp., 15 Del. Ch. 420, 429-30, 140 A. 264, 268 (Del. 1927), and Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966). *See* Pease, *Business Judgment Rule, supra* note 28, at 57. It is realized that as to this aspect of the article there is a risk that the discussion will fall within one of those "windy philosophical dissertations of professors on the Delaware business judgment rule . . . ." Prickett, *Henny-Penny, supra* note 62, at 453.

155. *See Aronson*, 473 A.2d at 812. Roswell Perkins, former president of the ALI, views the rule articulated by the ALI as more protective than the *Aronson* formulation because making the directors responsible for all material information reasonably available to them "would appear to call for the kind of in-depth research that is not practical within the time frame which surrounds most corporate decision making." Perkins, *ALI, supra* note 141, at 1210. The ALI's recommended business judgment rule is as follows:

duty of loyalty, a limitation not discussed in this article, or where they fail to act with proper care.[156] In addition, the protection of the rule is not available if the directors abuse their discretion.[157]

1. Limitation for Failure to Act with Care

The duty of care, according to *Aronson*, requires that directors inform themselves of all material information reasonably available and, having such information, act with requisite care.[158] The court said in *Trans Union* that "a director's duty to exercise an informed business judgment is in the nature of a duty of care . . . ."[159] But

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(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

(1) he is not interested . . . in the subject of his business judgment,

(2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances, and

(3) he rationally believes that his business judgment is in the best interests of the corporation.

ALI Draft No. 4, *supra* note 99, § 401(c).

156. *Aronson*, 473 A.2d at 812. The duty of loyalty will be violated if the directors (1) stand on both sides of a transaction, (2) have a personal financial interest not shared by the corporation and shareholders, and (3) lack independence because of domination and control by a person or group. *Id.*; *Pogostin*, 480 A.2d at 624. *See also* Pease, *Business Judgment Rule*, *supra* note 28, at 71.

157. *See Aronson*, 473 A.2d at 812. An eminent Delaware lawyer, now retired, wrote that an abuse of discretion is a judgment "that cannot be sustained on some rational basis." Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 122 (1979) [hereinafter Arsht, *Revisited*]. If, for example, the valuation fixed by the directors in a merger is so far removed from any fair valuation—a range of values recommended by financial advisers—the shield of the rule should not be available to them. Gimbel v. Signal Cos., 316 A.2d 599, 609 (Del. Ch. 1974); Cottrell v. Pawcatuck Co., 128 A.2d 225, 233 (Del. 1956). Another example of an abuse of discretion is illustrated by Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439-40 (Del. 1971), where the court enjoined the directors of Chris-Craft from changing the date of the annual meeting to obstruct the legitimate efforts of dissident stockholders to undertake a proxy contest. In addition, the Delaware Supreme Court in Gabelli & Co. v. Liggett Group, Inc., 479 A.2d 276 (Del. 1984), refused to interfere with the decision of the board not to declare a dividend in the absence of a showing of an abuse of discretion.

For discussions of the rule, see Hinsey, *Duty of Care, Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609 (1984) [hereinafter Hinsey, *Reality*]; Pease, *Business Judgment Rule*, *supra* note 28, at 62; Quillen, *Neutral Principles*, *supra* note 153, at 488-503; Veasey & 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 (1985) [hereinafter Veasey & Seitz, *Strange Porridge*].

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

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

the court's decision in *Trans Union* was not expressed in the language of an abstract duty of care. It arose from a specific finding that the directors did not act in an informed and deliberate manner in determining whether to approve a merger agreement before submitting the proposal to the stockholders.[160]

Further, the court said that the proper standard for determining whether a business judgment was informed is "gross negligence."[161] This term connotes reckless or cavalier conduct[162] and provides a more liberal standard for directors than is applicable to tradesmen, professionals, and workmen who are liable for ordinary negligence.[163]

2. Rule Only Applies to Board Actions

One restriction of the rule is that it is limited to director action; it offers no protection where directors have either abdicated their responsibility or, absent a conscious decision to refrain, failed to act.[164] The court in *Aronson* noted two cases, *Graham v. Allis Chalmers Manufacturing Co.*[165] and *Kelly v. Bell*,[166] where the directors' failure to act was erroneously held to be protected by the business judgment rule. Since the boards took no action in either case, the decision should have turned on whether the directors violated their duty of care.

Directors are protected by the rule if they consciously delegate decision making of a specific matter to reliable subordinates or outside parties. This is illustrated by a statement of the Delaware Supreme Court in *Rosenblatt v. Getty Oil Co.*:[167] "An informed decision to

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160. *Id.* at 874.

161. *Id.* at 873, 881. In *Aronson v. Lewis*, the court said that while the Delaware cases use a variety of tests to describe the applicable standard of care, its analysis satisfied the court that under the business judgment rule director liability is predicated upon concepts of gross negligence. *Aronson*, 473 A.2d at 812.

162. *See* Veasey & Seitz, *Strange Porridge*, *supra* note 157, at 1503; Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

163. *See* Prickett, *Henny-Penny*, *supra* note 62, at 456 & n.21. However, in the opinion of former Delaware Supreme Court Justice Quillen, "gross negligence" has been expressly rejected by the better tort scholarship as practically meaningless. Quillen, *Neutral Principles*, *supra* note 153, at 497.

164. *See Aronson*, 473 A.2d at 813. *See also* Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1485 (1984); Pease, *Business Judgment Rule*, *supra* note 28, at 76-79; Veasey & Seitz, *Strange Porridge*, *supra* note 157, at 1502.

165. 188 A.2d 125 (Del. 1963).

166. 254 A.2d 62 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. 1970).

167. 493 A.2d 929 (Del. 1985).

delegate a task is as much an exercise of business judgment as any other . . . . The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company."[168]

3. Application of the Rule in Takeover Cases

The Delaware Supreme Court has significantly restricted the business judgment rule in cases where boards of directors have adopted antitakeover measures. Indeed, one can question whether in Delaware the rule applies at all in such cases. Although the Delaware Supreme Court in *Pogostin v. Rice*[169] said that the business judgment rule is unqualifiedly applicable in the context of a takeover, in *Unocal* it retreated from this position, saying there are certain caveats to the board's business judgment when it addresses a pending takeover bid. The reason for this is

> [b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.[170]

The court then noted that because of the inherent conflict of directors in responding to a threat to the control of the company, directors have the initial burden of showing they had "reasonable grounds" for believing that a danger to corporate policy and effec-

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168. *Id.* at 943 (board delegated to an outside expert the subsurface asset valuation). *See also* ALI Draft No. 4, *supra* note 99, § 4.01(b).

169. 480 A.2d 619, 627 (Del. 1984).

170. *Unocal*, 493 A.2d at 954. The Court of Appeals for the Third Circuit in Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), did not so qualify the application of the rule. *See also infra* note 179 (discussion of court's application of business judgment rule); Wander & La Coque, *Jitters, supra* note 117, at 44-64 (most recent article that describes the different applications of the rule by Delaware courts as compared to the courts of other jurisdictions).

One recent federal district court case questioned whether the business judgment rule should apply at all in adopting defensive measures. In Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985), the court in applying New Jersey law noted the rule was developed to protect directors' judgments on questions of corporate governance with respect to purchases of equipment and wages and salaries. Defensive tactics, according to the court, raise a wholly different set of considerations. The court recognized, however, that the weight of authority dictates that the rule apply. *Id.* at 1259-60.

tiveness existed. This burden is satisfied by showing the directors' good faith and reasonable investigation.[171] The court then added a second test to its enhanced duty standard: "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise,"[172] exemplified as follows: (1) inadequacy of price offered; (2) nature and timing of the offer; (3) questions of illegality; (4) the impact on constituencies other than shareholders—creditors, customers, employees, and perhaps even the community generally; (5) the risk of nonconsummation; and (6) the quality of the securities being offered in the exchange.[173]

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171. *See Unocal*, 493 A.2d at 955. The court cited Cheff v. Mathes, 199 A.2d 548 (Del. 1964). *See also supra* note 52 and *infra* note 177.

In Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), the vice-chancellor addressing the problem with *Cheff* stated that the dispute over the burden of proof seems to turn on differing interpretations of the decision in *Cheff*. *Id.* at 1075. Vice-Chancellor (now Associate Justice) Walsh further noted that in his opinion the business judgment rule is primarily a tool of judicial review and only indirectly a standard of conduct for corporate management. *Id.* at 1076.

172. *Unocal*, 493 A.2d at 955. Chancellor Allen in AC Acquisitions Corp. v. Anderson Clayton & Co., No. 8584 (Del. Ch. Sept. 18, 1986), described the standard established by *Unocal*: "[W]here a board takes action designed to defeat a threatened change in control of the company, a more flexible, intermediate form of judicial review is appropriate." The standard, according to the chancellor, has two elements: "First, there must be shown some basis for the Board to have concluded that a proper corporate purpose was served by implementation of the defensive measure and, second, that measure must be found reasonable in relation to the threat posed by the change in control that instigates the action." *Id.* In that case the chancellor found that a self tender offer for 65% of the stock of the company and the sale of 25% of all issued and outstanding stock to an ESOP did not comply with the second element because this antitakeover measure precluded shareholders from accepting another offer. *Id.* at 25. The court said this was an intermediate standard of review between the business judgment rule and the standard of entire fairness. *Id.* at 20-21.

173. *Unocal*, 493 A.2d at 955. With respect to the "constituencies" consideration, the court in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), noted an exception "when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder." *Id.* at 182.

Pennsylvania in 1983 amended its standard of care statute to provide that a board of directors in opposing a takeover may consider, in addition to the stockholders, the employees, customers, suppliers, and the community. 15 Pa. Cons. Stat. § 1408(B) (1983) (amending 15 Pa. Cons. Stat. (1967)). *See* Newlin & Gilmer, *The Pennsylvania Shareholder Protection Act: A New State Approach to Deflecting Corporate Takeover Bids*, 40 BUS. LAW. 111, 113 (1984). See also the recently adopted Ohio statute which permits directors to consider the takeover's effects on employees and other groups. H 902 (to be codified at 1986 Ohio Laws).

The court reiterated the enhanced duty of the directors in relation to antitakeover measures in *Household International*,[174] *Revlon*,[175] and *Polk*.[176] In *Household International* the court stated that the directors have the burden of showing good faith and reasonable investigation and that the defensive mechanism was reasonable in relation to the threat posed. The burden then shifts to the plaintiffs who have the ultimate burden of persuasion to show a breach of the directors' fiduciary duties.[177] In *Unocal* the court explained the degree of proof required by the plaintiff to sustain his burden.

> [U]nless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.[178]

Thus, the court has articulated a version of the business judgment rule in takeover cases that excludes the threshold presumption that shields directors from liability. Rather, the directors initially must show that there is a harmful threat to the corporation and its shareholders, a burden that is met by establishing their good faith and reasonable investigation. Further, the directors have the responsibility of demonstrating that the preventive measure is reasonable in relation to the threat posed. As previously discussed, the burden of establishing

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The *Business Lawyer* article notes that when Standard Oil of California acquired Gulf Oil and its corporate headquarters was moved from Pittsburgh, that city lost hundreds of civic leaders, $2 million contributions to the United Fund and 2,000 jobs. *Id.* at 111. (citing Pittsburgh Post Gazette, Mar. 7, 1984, at 11).

174. *Household Int'l*, 500 A.2d at 1356.

175. *Revlon*, 506 A.2d at 180.

176. *Polk*, 507 A.2d at 537.

177. *Household Int'l*, 500 A.2d at 1356.

178. *Unocal*, 493 A.2d at 958. As to the business judgment rule a prominent lawyer and commentator on corporation law distinguishes between the business judgment rule and the business judgment doctrine. The rule insulates directors and management from personal liability; the doctrine protects the decision itself from liability. Hinsey, *Reality, supra* note 157, at 610-13. The Delaware Supreme Court in a note in the *Revlon* case referred to Mr. Hinsey's distinction, but concluded that "we do not alter our earlier practice of referring only to the business judgment rule, although in transactional justification matters such reference may be understood to embrace the concept of the doctrine." *Revlon*, 506 A.2d at 180 n.10. At least one commentator disagrees with Mr. Hinsey's distinction. *See* Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505, 506 n.4 (1985).

these requirements is reduced where the action is approved by a board having a majority of outside directors.[179]

Certainly one can question whether the Delaware Supreme Court has effectively abandoned the business judgment rule as to antitakeover measures even though it continues to speak of its applicability. Perhaps it would be preferable to describe the obligation of the directors in these cases as the "enhanced duty" rule, the expression used in *Unocal* to describe the directors' burden in defending against takeovers. Chancellor Allen in a recent case expressed the view that where a board takes action to defeat a threatened takeover, "a more flexible, intermediate form of judicial review is appropriate, one that is between the 'powerful' business judgment rule and the 'exacting' requirements of the standard of entire fairness."[180] The

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179. *See supra* notes 39-61. The court in *Household International* said that after the board establishes the reasonable grounds, the good faith and reasonable investigation and the reasonable relationship to the threat posed, the burden shifts back to the plaintiffs who have the ultimate burden of persuasion to show a breach of the director's fiduciary duties. *Household Int'l*, 500 A.2d at 1356.

Vice-Chancellor Walsh, now a justice of the Delaware Supreme Court, in his opinion explained "burden of persuasion":

> The *Cheff* standard requires the defendant directors to show that their adoption of the Plan was "reasonable at the time." The burden thus placed may be viewed as the burden of going forward on a showing of reasonableness rather than a burden of persuasion. Because of the protection afforded directors by the business judgment rule the latter burden does not shift and remains with the plaintiffs.

Household Int'l, 490 A.2d at 1376. Nevertheless, the presumption of the rule does not protect the directors if they fail in their threshold burden of establishing reasonable grounds, good faith, reasonable investigation, and reasonable relationship to the threat posed.

In Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981), in which the board fended off an attempted takeover by issuing control stock to a director, the court did not qualify the rule. Chief Judge Seitz (formerly Chancellor Delaware Court of Chancery) concluded that the presumption governs control situations "unless the plaintiff can tender evidence from which a fact finder might conclude that the defendant's sole or primary motive was to retain control . . . ." *Id.* at 293. For cases holding that a plaintiff alleging that the board had breached its fiduciary duty has the burden of proof in overcoming the rule's presumption, see Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980).

180. *See AC Acquisition Corp.*, No. 8584, slip op. at 20, 21. In the dissent in *Johnson*, the judge said that the function of control is so central to the issue of business judgment that the burden should be on the defendant director to justify that the transaction is in the corporate interest. *Johnson*, 629 F.2d at 301. Additionally, there is law review comment that the rule should not apply in takeover situations. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gelfond & Sebastian, *Reevaluating the*

chancellor did not place the business judgment rule in his articulation of this "intermediate form of judicial review" applicable to cases where the issue concerns the board's action to defeat an attempted takeover.

In any event, it seems proper that in adopting measures to prevent a change of control, directors should have to show that they had reasonable grounds for believing that the corporation and the shareholders would be harmed if the unfriendly offeror succeeded and that the action taken was reasonable in relation to the threat posed. Certainly, as the Delaware Supreme Court stated, directors have an inherent conflict in defending against an attempted unfriendly takeover; thus, they should satisfy the court that they are not acting solely or primarily to entrench themselves in office.

C. *Indemnification*

Indemnification provided in statutes and corporate bylaws offers significant protection for directors, particularly outside directors. Indeed, it affords more protection to directors than D&O insurance. A well-known commentator on corporation law stated that "[c]ompared to indemnification, D&O insurance protection is second best by a large margin."[181]

Section 145[182] of the DGCL, adopted in 1967 when the General Corporation Law of Delaware was comprehensively revised, au-

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Duties of Target Management in a Hostile Tender Offer, 60 B.U.L. REV. 403, 435-36 (1980).

Professor Hamilton commented in a recent law review:

> It appears that the Delaware Court is fashioning a new and more stringent version of the business judgment rule applicable to transactions involving the fundamental ownership rights of shareholders, without changing the traditional business judgment rule for other transactions. . . . . This effort contrasts widely with the simplistic, almost "knee jerk" reaction of the SEC to that court's decision in Mesa Petroleum v. Unocal, Inc., 493 A.2d 946 (Del. 1985).

Hamilton, *The State of State Corporation Law: 1986*, 11 DEL. J. CORP. L. 3, 10 (1986). *See generally* Lesser, *Directors Duties*, Nat'l L.J., Nov. 3, 1986, at 21, col. 1. In Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 273 (2d Cir. 1986), the court observed that in Delaware the initial burden is on directors to show reasonable grounds for believing that the takeover would endanger corporate policy; in contrast, under New York law the initial burden of proving directors' breach of fiduciary duty rests with the plaintiff.

181. Herzel, *Crisis, supra* note 3, at 103; Veasey, *Directors, supra* note 139, at 180-96.

182. DEL. CODE ANN. tit. 8, § 145 (1986). For a summary of § 145, the related cases, and other material, see Sparks, Johnston & Conan, *Indemnification and*

thorizes Delaware corporations to indemnify officers, directors, employees and agents, and persons serving in such capacities for other entities at the request of the corporation. The law distinguishes between indemnification in third party suits and suits brought by or in the right of the corporation—stockholder derivative suits. Third-party suits include civil, criminal, administrative, or investigative actions. The class suit in the *Trans Union* case is an example of a third-party action.

1. Mandatory Indemnification

First, with respect to either type of action, if the director is "successful on the merits or otherwise in defense of any action, suit or proceeding," section 145(c) requires the corporation to indemnify him.[183] The director has no *right* to indemnification under other provisions of section 145; the statute only *permits* the corporation to indemnify. There is little case law construing the phrase "successful on the merits or otherwise." In *Green v. Westcap Corp. of Delaware*,[184] the court concluded that an officer of Westcap who was successful on the merits in being acquitted of criminal charges had a right to indemnification even though there had been no disposition of the civil action against him in another jurisdiction. The court held that the officer did not have the additional burden of proving that he acted in good faith or in a manner he reasonably believed to be in or not opposed to the best interests of the corporation as required by sections 145(a) and (b) of the DGCL.[185] In *Merritt-Chapman & Scott Corp. v. Wolfson*,[186] indemnification was permitted for the defense

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Directors and Officers Liability Insurance: The Legal Framework Under Delaware Law, in ALI-ABA VIDEO LAW REVIEW, PROTECTING DIRECTORS AND OFFICERS IN AN ERA OF UNCERTAIN D&O LIABILITY INSURANCE STUDY 55 (1986) [hereinafter Sparks, *Framework*]. The 1967 revision substantially revised the former indemnification provision which appeared as § 122(10) of the previous DGCL. Green v. Westcap Corp. of Del., 492 A.2d 260, 265 (Del. Super. Ct. 1985).

183. Section 145(c) provides that if the specified persons have:

> been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b), or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith.

DEL. CODE ANN. tit. 8, § 145(c) (1983).

184. 492 A.2d 260 (Del. Super. Ct. 1985).

185. *Id.* at 264-65.

186. 321 A.2d 138 (Del. Super. Ct. 1974). Section 8.52 of the Revised Model Business Corporation Act requires that the corporation indemnify a director "who

of charges that ultimately were dropped, but the court denied indemnification as to a charge that resulted in a plea of *nolo contendere.*

2. Permissive Indemnification

Indemnification under section 145 is permitted in third-party actions for "expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding . . . ."[187] However, the corporation may indemnify the director only if he "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation . . . ."[188] With respect to criminal actions or proceedings, there is the additional requirement that the director had no reasonable cause to believe his conduct was unlawful.[189]

Presumably the requisite finding could have been made in *Trans Union* that the outside directors acted in good faith, thus permitting indemnification. The court noted that there were no allegations or proof of fraud, bad faith, or self dealing. The court, therefore, presumed that the directors reached their business judgment in good faith.[190]

The scope of indemnification in derivative actions is much more limited than in third-party litigation. Section 145(b)[191] only authorizes the indemnification of litigation expenses (including attorneys' fees); it does not permit reimbursement for amounts paid in satisfaction

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was wholly successful on the merits or otherwise." The word "wholly" was added to avoid the argument accepted in the *Merritt-Chapman & Scott Corp.* case "that a defendant may be entitled to a partial mandatory indemnification if he succeeded by plea bargaining or otherwise to obtain the dismissal of some but not all counts of the indictment." RMBCA, *supra* note 98, § 8.52.

187. DEL. CODE ANN. tit. 8, § 145(a) (1983).

188. *Id.*

189. *Id.*

190. *See Trans Union*, 488 A.2d at 873. Even so, there is a serious question as to whether directors who are adjudged 'grossly negligent" meet the second part of the § 145 test. They must not only prove their good faith, but also that they acted in a manner which they "reasonably believed to be in or not opposed to the best interests of the corporation . . . ." DEL. CODE ANN. tit. 8, § 145(a), (b) (1986). I should think that a disinterested quorum of a board or independent counsel would have difficulty finding that the Trans Union directors met their burden of satisfying that aspect of the test.

191. DEL. CODE ANN. tit. 8, § 145(b) (1986) (amending DEL. CODE ANN. tit. 8, § 145(b) (1983)), was enacted June 10,1986). The amended subsections of § 145 with the synopsis for each is attached as Appendix A.

of a judgment or in settlement of a claim. According to members of the Delaware Corporation Law Revision Committee, "to permit the corporation to nullify a judgment in its favor against a director simply by refunding the director's payment on it would, in the committee's judgment, subvert the substantive provisions of the corporation law and should not be permitted."[192] With respect to payment of settlements, the committee's view was that "to permit such indemnification would have the ultimate effect of discouraging settlements since, in such a situation, derivative plaintiffs could demonstrate no benefit arising to the corporation from their action and, presumably, could not justify being reimbursed for their litigation expenses, including counsel fees."[193]

Reimbursement for such litigation expenses in defending or settling derivative suits is subject to the same standards of section 145(a). Indemnification is authorized only if the director acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interest of the corporation. Before the recent amendments to section 145, no indemnification could be made as to any matter where the person was found liable for negligence or misconduct in the performance of his duties, unless the court of chancery or other court in which the action was brought determined that such person was entitled to indemnity.[194]

On July 1, 1986 section 145(b) was amended to delete the phrase "for negligence or misconduct in the performance of his duty" so that subsection (b) reads in its entirety as shown in appendix A. Thus, under the amended subsection (b), no indemnification for expenses can be made where the director has been adjudged liable to the corporation, unless the appropriate court determines that in view of all the circumstances of the case the director is fairly and reasonably entitled to indemnification. According to the legislative commentary, this amendment was adopted to conform "indemnification under the statute with the recent holdings of the Delaware Supreme Court [and that] [n]o substantive change in the law was intended."[195]

The term "good faith" in subsections (a) and (b) is not ex-

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192. Arsht & Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 79-80 (1967) [hereinafter Arsht & Stapleton, *Changes*].

193. *Id.*

194. *See* Appendix A (wording of § 145(b) before and after amendment).

195. *See* Appendix A (commentary on § 145(b)).

plained, but Messrs. Arsht and Stapleton stated that the words "or not opposed to" were

> intended to bring within the scope of permissible indemnification the officer or director who did not realize that his corporation had any interest at all in the subject matter of his action. Thus, the director who engages in a purely personal transaction, such as a purchase of stock or a business for his own account, and who reasonably believed that the corporation had no interest in the transaction, can be indemnified with respect to a suit charging that he had diverted to himself a corporate opportunity.[196]

3. Procedure to Authorize Indemnity

The procedure for making the requisite good faith determination is specified in section 145(d). Such a finding must be made by: (1) the board by a majority vote of a quorum of disinterested directors, or (2) if such a quorum is not obtainable, or even if obtainable such a quorum so directs, by independent legal counsel, or (3) by the stockholders.[197]

The authorization of independent counsel to make the required finding raises the question as to who may qualify. Such counsel should have had no previous professional relationship with the director seeking indemnification and, of course, should not be house counsel or the firm regularly used by the company.[198]

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196. Arsht & Stapleton, *Changes, supra* note 192, at 78-79. The commentary to the Model Act is that the "concept of good faith involves a subjective test, which would include 'a mistake of judgment,' . . . even though made unwisely by objective standards." RMBCA, *supra* note 98, § 8.51.

197. DEL. CODE ANN. tit. 8, § 145(d) (1983).

198. RMBCA, *supra* note 98, § 8.55. Section 8.55 refers to "special" counsel rather than independent counsel. The comment to this section states that special legal counsel "should normally be counsel having no prior professional relationship with those seeking indemnification, should be retained for the specific occasion, and should not be either inside counsel or regular outside counsel."

In Schmidt v. Magnetic Head Corp., 97 A.D.2d 151, 468 N.Y.S.2d 649, 655 (N.Y. App. Div. 1983), the court held that an attorney qualified as "independent legal counsel" even though he was retained by a partner in a law firm that represented the corporation and the directors who were parties to the litigation. The court noted that the attorney selected as independent counsel had no previous professional relationship with the parties. *See* RMBCA, *supra* note 98, § 8.56. *See also* Pease, *Indemnification Under Section 145 of the Delaware General Corporation Law*, 3 DEL. J. CORP. L. 167, 170-71 (1978).