



Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law

Author(s): William T. Allen, Jack B. Jacobs and Leo E. Strine, Jr.

Source: *The Business Lawyer*, August 2001, Vol. 56, No. 4 (August 2001), pp. 1287-1321

Published by: American Bar Association

Stable URL: <https://www.jstor.org/stable/40688020>

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at <https://about.jstor.org/terms>



American Bar Association is collaborating with JSTOR to digitize, preserve and extend access to *The Business Lawyer*

JSTOR

Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law

By William T. Allen, Jack B. Jacobs and Leo E. Strine, Jr.*

THE IMPORTANCE OF CORPORATION LAW

How legal systems organize and coordinate economic factors of production within firms contributes importantly to the production of wealth in any society. In our market-centered liberal democracy, that function is facilitated by the law of property, contract, agency, partnership, and corporations, among other fields. Few, of course, would claim that the law of business organization is the primary driver of a society's economic productivity.¹ More elementary variables such as technology, education, availability of capital, and even social values such as diligence and self-restraint, are vital ingredients as well. But at least since the collapse of the Soviet-style planned economy as a potential alternative system, it has been clear, even to those who could not see it before, that the law of enterprise organization plays an important role in facilitating economic welfare. That

* William T. Allen is Professor of Law and Clinical Professor of Finance, New York University; former Chancellor of the court of chancery of the State of Delaware, 1985-1997. Jack B. Jacobs is Vice Chancellor of the court of chancery of the State of Delaware. Leo E. Strine, Jr. is Vice Chancellor of the court of chancery of the State of Delaware. The authors appreciate the useful comments provided to them by Professor Lawrence A. Hamermesh of Widener University School of Law. This Article was prepared in connection with a May 23, 2001 seminar on corporate standards of review coordinated by Professor Hamermesh for the Widener University Institute of Delaware Corporate Law and the Delaware State Bar Association. The authors also appreciate the help of Karlis P. Walker, Wendy Goldberg, and Marc Bonora in preparing this Article.

1. The law and finance literature dealing with the productivity effects of differing legal systems has, however, grown large in recent years. A rich new body of thought-provoking work by Professors La Porta, Lopez-de-Silanes, Shleifer, and Vishny, for example, argues that the legal protections afforded to minority stockholders contribute importantly to the creation of effective and richly capitalized securities markets. See generally Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); LA PORTA ET AL., INVESTOR PROTECTION AND CORPORATE VALUATION (National Bureau of Econ. Research Working Paper No. 7403, 1999) (on file with *The Business Lawyer*, University of Maryland School of Law); Lopez-de-Silanes et al., *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1 (2000).

body of law includes matters such as protection of investors' voting rights, minority investors' legal protections generally, and the presence and integrity of enforcement mechanisms.² In this connection, the federalist U.S. legal regime of required information disclosure and its flexible law of organization is treated as a de facto world standard,³ and as to the latter, the law of a single U.S. jurisdiction, Delaware, is of paramount importance.

Highly significant in this regard is the law of business organization form, which includes the law of partnerships, trusts, agency, and other related fields. The form of enterprise organization that for the past century has been most important to the production of wealth in the modern economy is the corporation. The central features of the corporate form—fictitious entity status and limited liability of investors, indefinite existence, centralized management, and transferable share interests—make that form an extremely efficient way to aggregate the large pools of capital that are essential to finance large scale enterprise. That organizational form also allows the separation of the operating management role from the role of providing risk capital, facilitates the specialization of function, and affords owners of capital the great benefits of inexpensive diversification.

Although efficient, the corporate form is not perfectly so. During much of the last century, scholars and others have observed that an effect of large capital markets and shareholder diversification has been to create a largely passive class of capital investors. In most large-scale organizations, economic logic foreclosed these investors from closely supervising the managerial agents whose expertise and access to information enabled the agents to operate these large firms more effectively. The separation of ownership and control thus posed the question of how to instill confidence in investors that their capital would be deployed with fidelity to their interests. Because the United States relied heavily on capital markets as the way to aggregate capital, one method of giving such assurance was to regulate the national securities markets so as to guarantee a flow of ac-

2. The effect of these legal or normative protections on the value of corporations has commanded considerable academic and policy attention. See, e.g., Bernard Black, *Does Corporate Governance Matter?: A Crude Test Using Russian Data*, 149 U. PA. L. REV. (forthcoming July 2001); John C. Coffee, *Do Norms Matter?: A Cross-Country Examination of the Private Benefits of Control*, 149 U. PA. L. REV. (forthcoming July 2001); TATIANA NENOVA, *THE VALUE OF CORPORATE VOTES AND CONTROL BENEFITS: A CROSS-COUNTRY ANALYSIS* (Harvard University Econ. Working Paper, 2000) available at <<http://www.ssrn.com>>.

3. It was not ever thus. Only a few years ago a substantial minority of corporate law academics posited that the "patient" capital supplied by German banks, the Japanese keiretsu and Korean chaebol might offer efficiency advantages over the U.S. system of corporate governance. Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 872 (1993); Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 FORDHAM L. REV. 161, 177-78 (1992); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1948 (1993).

curate and meaningful financial information about publicly-traded corporations. In that vital task the substantive corporation law also had a critical role to play.

By and large, substantive corporation law has had two main functions. The first is to establish and enforce the structural elements of the corporate form and provide certain default rules to govern that form. To that end, substantive corporate law instructs individuals on what steps are necessary to create a legal entity and what powers, in default of other elections firm designers are permitted to make, centralized management will possess. The corporation law also establishes certain mandatory shareholder rights.

Over the course of the twentieth century, the mandatory features of the statutory law gradually decreased. Statutes became increasingly elegant and flexible, continuously moving away from a mandatory or prescriptive model and ever closer to a pure contractual or enabling model.⁴ As a consequence, what emerged as a counterpoint to the evolution of the enabling model of corporation law was the second key function of the law of corporations: the *ex post* judicial review of the actions of corporate officers and directors, measured by fiduciary principles. Fiduciary review imported into corporate law the centuries-old equity tradition that subjected the conduct of fiduciaries to judicial supervision. Corporate directors came to be viewed as a species of fiduciary, not so constrained as trustees or executors to be sure, but subject nonetheless to a pervasive duty of loyalty when exercising their broad powers over corporate property and processes.

The fiduciary duty of corporate officers, directors, and controlling shareholders has been a protean concept that has generated not only much of what is novel and interesting in modern corporation law, but also much of what is frustrating.⁵ That concept has been used primarily in three categories of cases.

4. For example, purposes clauses grew to great breadth, and the *ultra vires* doctrine essentially disappeared. Maximum amounts of permitted capital (and minimum required amounts) were eliminated. Par value of stock and pre-emptive rights were made voluntary. Cash-out mergers became permissible. This evolution drove Professor Bayless Manning to rhetorical heights rarely encountered in the dry terrain of corporation law when he commented on the broadly “enabling statutes of the late 20th century”:

[C]orporation law as a field of intellectual effort is dead in the United States. When American law ceased to take the “corporation” seriously the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind.

Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

5. As a set of principles governing behavior of agents or trustees, fiduciary law offers both great potential benefits to the corporation law and great potential costs. In theory the fiduciary principle can reduce the risks to which capital is exposed without unduly constraining

The first category involves claims that directors did not act with requisite care. Generally, before the 1980s the director's duty of care received little or no notice in Delaware. Directors were presumed (all but conclusively) to have behaved as reasonable persons would. Where courts encountered troubling instances of director action in cases where the directors had no apparent conflict of interest, the courts were inclined to ask loyalty-based questions, such as whether the action constituted a fraud or a "constructive fraud" against the corporation or its minority shareholders.⁶ That is, instances of apparent director negligence triggered an inquiry into whether a breach of the duty of loyalty had occurred, thereby rendering the duty of care essentially unenforceable as a stand-alone concept. After 1985, however, the duty of care emerged in Delaware as an independently enforceable obligation, and has become one of the three typical categories of cases with which courts applying fiduciary principles must deal.

The second category—duty of loyalty claims—has the longest pedigree. That category addresses primarily (but not exclusively) situations involving self-dealing, wherein the duty of loyalty is rigorously enforced by requiring the directors to justify as intrinsically fair any transaction in which they had a financial interest.

Since 1985, a third category has more clearly emerged: cases where the directors have no direct pecuniary interest in the transaction but have an "entrenchment" interest, i.e., an interest in protecting their existing control of the corporation. In keeping with the traditionally intense focus on loyalty, the corporation law has always been concerned with corporate control and, in particular, with whether directors have acted to advance their personal self-interest by entrenching themselves in office.⁷ Before 1985,

the ability of managers to react to changing markets, tastes and technologies. But the great breadth of the fiduciary concept inserts substantial uncertainty into the transaction planning process. In the wrong hands, the fiduciary principle could be a source of substantial risk to proposed transactions. It is, we think, an accurate observation that the net welfare effect of the fiduciary duty idea in corporation law has been decidedly positive. Still, ongoing efforts to reduce uncertainty while maintaining reasonable *ex post* protections for investors are also socially necessary and desirable. It is in the spirit of striving to increase the clarity and coherence of the application of fiduciary principles to corporation law that we offer these comments on the evolution of corporate law doctrine over the last fifteen years or so.

6. William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in COMPARATIVE CORPORATE GOVERNANCE, 307, 321-24 (Klaus J. Hopt et. al. eds., 1998) [hereinafter Allen].

7. Cf. *Speiser v. Baker*, 525 A.2d 1001, 1009 (Del. Ch. 1987) ("Almost from the earliest stirrings of a distinctive body of law dealing with corporations, courts have been alert to the dangers posed by structures that permit directors of a corporation, by reason of their office, to control votes appurtenant to shares of the company's stock owned by the corporation itself or a nominee or agent of the corporation.") (citing *Ex parte Holmes*, 5 Cow. 426 (N.Y. Sup. Ct. 1826); *In re Barker*, 6 Wend. 509 (N.Y. Sup. Ct. 1830); *Brewster v. Hartley*, 37 Cal. 15 (Cal. 1869); *Monseaux v. Urquhart*, 19 La. Ann. 482 (La. 1867); *American Railway-Frog Co. v. Haven*, 101 Mass. 398 (Mass. 1869); *Allen v. De Lagerberger*, 10 Ohio Dec. Reprint 341 (Oh. Super. Ct. 1888)).

however, the entrenchment cases were never rationalized under a coherent theory. Instead, they were adjudicated under a standard vaguely akin to “fairness” or “improper motive.”⁸ Taken as a whole, therefore, the pre-1985 law had a somewhat simpler structure than Delaware corporation law presently has, and it operated primarily to protect stockholders from purposeful wrongdoing, self-dealing, or inequitable acts of entrenchment.

THE REVOLUTION IN DELAWARE CORPORATION LAW

Since 1985, unprecedented developments in both the capital and the international product markets created the environment for Delaware’s courts to modify this traditional structure, by vastly expanding the jurisprudence addressing the third category of cases.⁹ In the process, little or nothing in corporation law was left exactly as it existed before. The duty of care evolved from a rarely thought about concept to an enforceable duty that came to occupy a more central place on the corporate law stage. Additionally, the duty of loyalty and its intrinsic fairness standard did not escape the tectonic forces of the changes wrought by the takeover era either.

In our view, the results of those changes, viewed collectively and from a policy perspective, were balanced and productive. From a technical corporation law perspective, however, those results were often rationalized in a manner that gave inadequate guidance to lawyers whose task was to plan, and render advice to clients about, transactions based upon these post-1985 judicial opinions. Indeed, the multi-billion dollar transaction between two major corporations reviewed in *Paramount Communications, Inc. v. QVC Network, Inc.*¹⁰ was based explicitly on one such opinion.¹¹ Never-

8. See, e.g., *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (concluding that it was inequitable for corporate management to use the corporate machinery to perpetuate itself in office and obstruct the “legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management”); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 775 (Del. Ch. 1967) (striking down as inequitable an issuance of shares that had the primary purpose of preventing a change of control to a stockholder who would have otherwise had a majority of the shares); *Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236, 239 (Del. Ch. 1953) (“As a starting point it must be conceded that action by majority stockholders [in issuing stock to themselves] having as its primary purpose the ‘freezing out’ of a minority interest is actionable without regard to the fairness of the price.”) (citing *Allaun v. Consol. Oil*, 147 A. 257, 261 (Del. Ch. 1929); *Bodell v. General Gas*, 140 A. 264, 268 (Del. 1927)); *Yasik v. Wachtel*, 17 A.2d 309, 313 (Del. Ch. 1941) (“It is a breach of [fiduciary] duty . . . for directors to make use of the issuance of shares to accomplish an improper purpose, such as to enable a particular person or group to maintain or obtain voting control . . .”).

9. A large body of fiduciary duty doctrine has also arisen in the area of disclosure. The idiosyncrasies of that body of law are beyond the scope of this Article.

10. 637 A.2d 34 (Del. 1994).

11. In *QVC*, the Viacom-Paramount merger agreement was justified under the rationale of the Delaware supreme court as stated in its last decision bearing on the subject, *Paramount*

theless, considering the difficulties of the fundamental questions being presented and the speed with which judges were required to craft much of the new law of corporate mergers and acquisitions, this imperfection is understandable.¹²

This Article focuses on a central aspect of the protean growth in the conceptual vocabulary of the Delaware corporation law since 1985—judicial standards of review. Our thesis is that certain key Delaware decisions articulated and applied standards of review without adequately taking into account the policy purposes those standards were intended to achieve. Moreover, new standards of review proliferated when a smaller number of functionally-thought-out standards would have provided a more coherent analytical framework. In this Article, we suggest a closer alignment between the standards of judicial review used in Delaware corporate law and the underlying policies that that body of law seeks to achieve.¹³ In our view, a rigorous functional evaluation of existing corporate law standards of review will clarify their application, reduce their number, and facilitate the task of corporate advisors and courts. We begin such a task here.

Communications, Inc. v. Time Inc. (Time-Warner), 571 A.2d 1140 (Del. 1990). In *Time-Warner*, the court affirmed the ruling of the Chancellor that the Time-Warner combination did not invoke duties under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), but explicitly premised its affirmance on a different rationale than the court of chancery had used. *Time-Warner*, 571 A.2d at 1150. Under the Chancery approach in *Time-Warner*, the later Viacom-Paramount merger would clearly have invoked *Revlon*. Under the supreme court's *Time-Warner* opinion, it was far less clear that the Viacom-Paramount merger implicated *Revlon*. In *QVC*, the Delaware supreme court embraced the Chancery approach in *Time-Warner*, holding that the Viacom-Paramount merger triggered *Revlon* scrutiny, but disclaiming any responsibility for causing confusion among the transactional planners. *QVC*, 637 A.2d at 46-48 (embracing rationale used by Chancery Court in *Time-Warner* case and indicating that this should not have been surprising).

12. Cf. William T. Allen, *Our Schizophrenic Conception Of The Business Corporation*, 14 CARDOZO L. REV. 261, 275 (1992) (pointing out that during the 1980s and 1990s the Delaware courts were asked to make public policy regarding the appropriate conception of the American corporation when views about that issue were sharply divided and no side of the issue was supported by a widely accepted legal doctrine).

13. By "corporation law" we mean "equity" cases, where the issue is whether corporate directors and/or officers have satisfied their fiduciary duties in a specific situation, as distinguished from corporate law cases that involve "legal" issues such as whether the disputed corporate action was authorized by statute and/or by the corporation's governing instruments. The issue in the equity corporate cases is not whether corporate fiduciaries had the power to take the challenged corporate action, but whether they exercised that power properly. The introduction of the normative concept of "proper exercise" of legal power is what has driven the creation of new standards of review from and after 1985. The seminal case in this area in many respects is *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971), which held that "inequitable action does not become permissible simply because it is legally possible." *Id.* at 439. The other type of corporate law cases are not the primary focus of this Article, because they do not ordinarily give rise to the "standard of review" problems addressed here.

Our analysis concludes by proposing that the corporation law can function most effectively with three basic standards of judicial review: (i) a gross negligence standard of review for claims that directors are liable for damages caused by their inattention—a standard that would require a plaintiff to prove both a breach of the duty and the fact and extent of any damages caused by the breach; (ii) a rehabilitated entire fairness standard to address duty of loyalty claims; and (iii) an intermediate standard of review to govern challenges to director decisions arguably influenced by an entrenchment motive, e.g., the adoption of antitakeover defensive measures or the approval of a change of control.

DOCTRINE THAT GROWS AND KEEPS ON GROWING

The transition from the older body of law, developed during the 1920-1980 period, to the current design of Delaware corporation law was not easy, nor, in some respects, especially pretty. From 1985 through 1993, the corporation law applied to M&A transactions was in a difficult state.¹⁴ During that period and thereafter, courts endeavored to shape the revolutionary 1985 and 1986 decisions of *Van Gorkom*, *Unocal Corp. v. Mesa Petroleum Co.*,¹⁵ and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹⁶ into a consistent and coherent body of legal doctrine. During this period many large public corporations became subject to hostile takeovers—with threatened losses to creditors, management, labor, and perhaps even shareholders. State corporation law played an important part in those transactions, in great part because there was no clear national policy addressing how this phenomenon should be regulated.¹⁷ Although discrete political interest groups were activated by these forces, no one view was able to so dominate the others as to have its preferences expressed as federal law. In that national law vacuum, the state law fiduciary duty of corporate directors became by default the judicial tool with which an accommodation was—and still is—being crafted.¹⁸

14. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); see also *QVC*, 637 A.2d 34.

15. 493 A.2d 946 (Del. 1985).

16. 506 A.2d 173 (Del. 1986).

17. Cf. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Power* (Apr. 21, 2001) available at <<http://www.law.umich.edu/centersandprograms/olin/confpapers/thompson.pdf>> at 19 (“Indeed the key regulatory move of the 1980s in corporate takeovers was the rise of fiduciary duties as the primary means to sort out legal claims regarding the ability of directors to limit or thwart the collective use of shareholder selling. Fiduciary duty held center stage overpowering possible alternatives such as direct shareholder action to vote or sell shares, the regulatory provisions of the Williams Act, or the unfettered dictates of the market.”) (footnote omitted).

18. That was to some extent the result of the United States Supreme Court decision in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), which held that the substantive fairness of transactions involving the purchase or sale of securities was the concern of state courts and state corporation law, and not a federal securities law concern. *Id.* at 479. As other scholars have noted, *Santa Fe* continued a pattern of federal deference to the substantive law

The difficulties with the common law case-by-case form of fiduciary regulation are several. By its nature fiduciary duty law is an imperfect tool to forge rules to regulate a phenomenon as complex and policy-laden as corporate takeovers. Being highly general, prospective statements of the content of fiduciary duties offer limited guidance to transaction planners who seek legal certainty from authoritative judicial decisions. Moreover, as applied in specific cases the articulated fiduciary duty is often so highly particularized that it becomes difficult to generalize *ex ante* rules from those judicial holdings. To express it differently, the almost infinite potential variation in the fact patterns calling for director decisions, the disparate time frames within which different boards may be required to act, and the divergent skills and information needed to make particular business decisions, usually make it impossible for courts to articulate *ex ante* precise guidelines for appropriate fiduciary action in future cases. Given the blunt nature of the fiduciary doctrine tool, judges must instead describe fiduciary duties in general terms that can (it is hoped) be sensibly and fairly applied in future diverse circumstances in which directors are called upon to act.¹⁹ In discharging this task, judges also face the difficulty of bringing *legal* expertise to bear in reviewing the decisions of *business* professionals, an exercise inherently fraught with risks of error.

Required to develop a body of rules to impose legal order upon a phenomenon (a dynamic revolution in corporate merger activity) that no other governmental authority had stepped forward to regulate, and equipped with but the bluntest of tools, the Delaware courts employed the fiduciary duty doctrine to evaluate the decisions of corporate directors in a multitude of circumstances. Fulfilling that role inspired the courts to innovate, because the new forms of merger transactions and the board responses to unsolicited takeover bids seemed to demand more flexible judicial tools specifically adapted to this unprecedented phenomenon. The end result was the articulation by Delaware courts of new standards of review in cases such as *Unocal*, *Revlon*, and *Blasius Industries, Inc. v. Atlas Corp.*,²⁰ all within a relatively short time frame.

With these new standards also came the concern, however, that the case law would lose overall policy coherence. In response to that concern, the decisional law attempted to link all the disparate review standards together by using the business judgment rule as the medium.²¹ That is, while striving to exploit the functional utility of situationally-specific standards of

of states flowing out of the *Erie* doctrine. See William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 DEL. J. CORP. L. (forthcoming 2001) (attributing the emergence of the Delaware courts' central role in American corporate law in large measure to *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938)).

19. Allen, *supra* note 6, at 310.

20. 564 A.2d 651 (Del. Ch. 1988).

21. See, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

review, the cases at the same time also attempted to adhere to the tradition of deference to well-motivated director action that is both a hallmark of Delaware corporation law and the critical premise of the business judgment rule standard of review.

The motive that drove the linkage to the business judgment rule was laudable, but the fit turned out to be less than optimal. Experience has demonstrated that although some of the era's innovations were quite useful, others threatened to dilute core values of corporation law. Recognizing that this era in Delaware corporation law produced generally efficient, but not perfect, results we submit that a few mid-course corrections are needed to preserve the benefits of those innovations and eliminate their dysfunctions.

THE ATTRIBUTES OF FUNCTIONAL STANDARDS OF REVIEW

A logical beginning point for our effort is to define the term "standard of review" and identify the attributes that a well-crafted review standard should have. A judicial standard of review is a value-laden analytical instrument that reflects fundamental policy judgments. In corporate law, a judicial standard of review is a verbal expression that describes the task a court performs in determining whether action by corporate directors violated their fiduciary duty. Thus, in essential respects, the standard of review defines the freedom of action (or, if you will, deference in the form of freedom from intrusion) that will be accorded to the persons who are subject to its reach.

There exists a close, but not perfect, relationship, between the standard by which courts measure director liability (the "standard of review") and the standard of behavior that we normatively expect of directors (the "standard of conduct"). As Professor Melvin Eisenberg expressed this idea in his thoughtful article on corporate standards of review, "[a] *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."²² Standards of conduct are sometimes referred to as "conduct rules" that are addressed to corporate directors and officers, whereas standards of review are "decision rules" that are addressed to judges.²³

22. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993) [hereinafter Eisenberg]. Professor Eisenberg's article built on another important article regarding standards of review by Meir Dan-Cohen. See Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 *HARV. L. REV.* 625 (1984).

23. Eisenberg, *supra* note 22, at 462.

In most areas of law, standards of conduct and standards of review tend to conflate and become one and the same,²⁴ but in corporate law the two standards often diverge. The reasons are rooted in policy interests. First, directors must make decisions in an environment of imperfect information. Second, given the limited investment in publicly held firms that typical corporate directors are able or willing to make, any risk of liability would likely dwarf the incentives for assuming the role. Third, courts are ill-equipped to determine after-the-fact whether a particular business decision was reasonable in the circumstances confronting the corporation.²⁵

The interplay of these considerations can be illustrated by considering how judges review board decisions under the business judgment standard. Where the business judgment standard applies, a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational.²⁶ In this review context, the business judgment standard (“rationality”) diverges from, and becomes more lenient than, the normative standard of expected conduct (“reasonableness”).²⁷ The justifications for this divergence have been thoroughly stated elsewhere, and will not be repeated here. Suffice it to say that we endorse a corporate law regime which affords substantial freedom of action to disinterested, well-motivated directors.²⁸

The aim of this Article is to highlight some important ways that the current array of Delaware standards of review imperfectly advance the core values of our corporation law and to propose some improvements. Those topics are important because standards of review reflect significant value judgments about the social utility of permitting greater or lesser insulation of director conduct from judicial scrutiny. Standards of review also function as a disciplinary mechanism to reduce the likelihood of er-

24. Professor Eisenberg cites as an example of the conflation of standards of conduct that governs an automobile driver (which is that he should drive carefully) and the standard of review in a liability claim against a driver (which is whether he drove carefully). *Id.* at 437. Similarly, the standard of conduct governing an agent who engages in a transaction with his principal that involves the subject matter of the agency is that the agent must deal fairly, and the standard of review of a liability claim by the principal against the agent based on such a transaction is whether the agent dealt fairly. *Id.* In both examples, there is no difference between the standard of conduct and the standard of review.

25. *Id.* at 437-38; see generally Allen, *supra* note 6.

26. Eisenberg, *supra* note 22, at 443.

27. E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 692 (1998) [hereinafter Veasey] (expressing opinion that there is a distinction between the concepts of reasonableness and rationality and citing *Brazen v. Bell Atlantic Corp.*, 695 A.2d 43, 49 (Del. 1997) and E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 930-42 (1980) in support of that proposition).

28. For a more developed articulation of the authors' views on this point, see William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: a Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 95 NW. U. L. REV. (forthcoming in 2001).

recessive judicial decisions that might deter director risk-taking. Our core thesis is that because standards of review serve important policy functions, to formulate or apply those standards without being sufficiently mindful of those functions, risks creating unintended distortions of incentives to the detriment of stockholders. Additionally, the creation of more, rather than fewer, standards of review tends to create a false sense of doctrinal safety, encouraging boards to act in ways that, although enabling their actions to fall into the right categorical box, does not necessarily create the result most genuinely protective of the interests of stockholders.

In developing a streamlined set of review standards, our fundamental guidepost is an emphasis on functionality.²⁹ To be functional, a standard of review should:

- (i) provide judges with a practical and logical framework to determine whether corporate directors have fulfilled their duties in a particular context and the appropriate remedies if they have not;
- (ii) avoid needless complexity that creates opportunities for inefficient processing of cases that have little likelihood of ultimate success; and
- (iii) be aligned with the public policies that animate the corporate law by providing incentives for directors to act in a manner most likely to advance corporate and stockholder interests, and by deferring to outcomes reached through effective intra-corporate dispute resolution mechanisms.³⁰

To us, a reliable test of whether a standard of review is truly functional is utilitarian: is the standard a useful tool that aids the court in deciding the fiduciary duty issue? If a review standard does not do that, if all it does is signal the result or outcome, then the standard is not functional in any analytically helpful sense. As thus viewed, the “business judgment rule” is not, functionally speaking, a standard of review at all. Rather, it is an expression of a policy of non-review of a board of directors’ decision when a judge has already performed the crucial task of determining that certain conditions exist.

29. See Veasey, *supra* note 27, at 699-700. “[C]ourts should try to use a coherent, economic rationale as a point of departure in their decisionmaking in corporate cases.” *Id.* at 681.

30. The functionality of review standards will also vary significantly depending on the procedural context. The review standard that is functional to determine whether a board action, not yet consummated, should be enjoined, may be inappropriate as the review standard in cases where the issue is whether some or all of the directors should be held liable to pay money damages for an improper board decision that cannot be undone. Unfortunately, corporate law decisions have often conflated standards of review directed at whether a board’s decision to approve a transaction should be upheld, with the standard directed at the very different question of whether particular directors committed misconduct that would support an award of money damages against them. *Cf. Emerald Partners v. Berlin*, 726 A.2d 1215 (Del. 1999). Only by identifying the policy values that undergird standards of review can courts begin to formulate and apply those standards in a truly functional way.

In the cases, a standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process.³¹ Under those circumstances, the directors' decision is reviewed not for reasonableness but for rationality. If those conditions to the application of the standard are met, however, it is as a practical matter impossible that the resulting decision can be found irrational.³² Even for those who might seek to assert that there is a theoretical basis to impose damages upon or set aside the decision of a director who is independent, careful, and acting in good faith, it remains a fact that in the real world such cases constitute a null set. A standard of review that inevitably leads to no case where liability is imposed—the business judgment standard—is not a functionally useful analytical tool to actually decide cases.

Put another way, the truly functional standard of review is the test actually used by the judge to reach a decision, not the ritualistic verbal standard that in truth functions only as a conclusory statement of the case's outcome. For that reason as well (and as we discuss later in more detail), the current effort under Delaware to link the "intermediate" and "entire fairness" standards of review to a theoretically all-encompassing "business judgment rule" standard creates dysfunctions that confuse, rather than aid, the resolution of fiduciary duty cases. Accordingly, we argue that if there is a need for a situationally-specific standard of review to evaluate particular board decisions (e.g., *Unocal*'s enhanced reasonableness review),³³ it is functionally preferable to incorporate the general policy value of deferential review reflected in the business judgment rule directly into that situationally-specific standard.³⁴

To develop those points we examine several Delaware decisions that illustrate these standard-of-review-related problems: (i) *Van Gorkom* and the review standard in duty of care cases;³⁵ (ii) *Cede & Co. v. Technicolor, Inc.* (*Cede II*)³⁶ and its linkage of the duty of care to "entire fairness" review;³⁷ (iii) *Kahn v. Lynch Communication Systems, Inc.*³⁸ and its failure to defer to intra-corporate fairness procedures;³⁹ (iv) *Unocal* and *Unitrin, Inc. v. American*

31. Eisenberg, *supra* note 22, at 441 (summarizing these elements); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (articulating same basic elements).

32. And as a normative matter, if the four conditions are met, what moral or practical basis is there for the law to impose liability on a director?

33. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

34. *See, e.g., Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995), which requires the court to defer if it finds that the directors' defensive choice was within a range of reasonable alternatives.

35. *See infra* text accompanying notes 43-55.

36. 634 A.2d 345 (Del. 1993).

37. *See infra* text accompanying notes 56-70.

38. 638 A.2d 1110 (Del. 1994).

39. *See infra* text accompanying notes 71-83.

*General Corp.*⁴⁰ and their linkage of the intermediate “reasonableness,” standard of review to the business judgment and entire fairness standards;⁴¹ and (v) *Blasius* and the issue of “too many” review standards.⁴² Analysis of these problems leads us to propose a simplified set of proposed review standards that, because they are functional, would better serve their intended policy goals.

VAN GORKOM AND THE STANDARD OF REVIEW IN DUTY OF CARE CASES

As we and others have more fully explained elsewhere, Delaware law traditionally treated claims that directors breached their duty of care differently from claims that directors breached their duty of loyalty. So long as the directors acted in subjective good faith, the courts avoided imposing liability.⁴³ Only towards the end of the twentieth century did Delaware’s corporation law first accord “bite” to the duty of care. When it took that step, the law reflected the policy concern that an overly aggressive approach to enforcing the duty of care could deter risk-taking and discourage service on corporate boards by qualified candidates.

Thus, in *Aronson v. Lewis*, the Delaware supreme court announced that the standard of review of claims that directors breached their duty of care is “gross negligence,”⁴⁴ a standard facially far more lenient than the simple “negligence” standard of conduct. For that reason, it was thought that following *Aronson*, the standard of review and the standard of conduct in due care cases would continue to diverge as a matter of public policy, and that where director liability was the issue, the judicial review inquiry would be whether the board’s conduct constituted gross negligence. Applying that review standard would fulfill the policy and fairness requirements that dictated using a standard of review more lenient than the standard of conduct (e.g., “rationality,” as opposed to “reasonableness” in business judgment rule cases). Unfortunately, that expectation was not realized. Instead, in two later decisions the Delaware supreme court, although purporting to apply the gross negligence standard of review, in reality applied an ordinary negligence standard.

*Smith v. Van Gorkom*⁴⁵ was the first case where that occurred. There, the Delaware supreme court held outside directors liable for damages in approving a sale of the corporation at a fifty percent premium over the stock market price.⁴⁶ The gross negligence consisted of the board having failed

40. 651 A.2d 1361 (Del. 1995).

41. See *infra* text accompanying notes 84-95.

42. See *infra* text accompanying notes 96-116.

43. Allen, *supra* note 6, at 318-24.

44. 473 A.2d 805, 812 (Del. 1984) (“[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.”).

45. 488 A.2d 858 (Del. 1985).

46. *Id.* at 893.

(i) to require an independent valuation of the corporation or, alternatively, a reliable post-signing “market check;” (ii) to negotiate an adequate “no shop” clause that would enable the board to consider a higher offer and give the board a reasonable basis to terminate the agreement; and (iii) to resist the CEO’s domination of the decisionmaking process leading to the sale of the company.⁴⁷

Because this famous case has been commented on so frequently, we will not dilate on the underlying facts here. Suffice it to say that the alleged failures of process that supported the court’s holding may have amounted to ordinary negligence, but it is difficult to argue that they constituted gross negligence, which involves a devil-may-care attitude or indifference to duty amounting to recklessness.⁴⁸ By abandoning the gross negligence review standard in deed albeit not in word, the supreme court withdrew much of the comfort and greater incentive for risk-taking promised by that more lenient standard.⁴⁹

That this was not an inadvertent oversight was confirmed eight years later in *Cede II*,⁵⁰ a case that has also generated critical commentary.⁵¹ There, outside directors who had approved an arm’s-length-negotiated sale of their company to an unrelated third party, in reliance upon the advice of independent counsel and investment bankers, were found to be (based upon an *arguendo* assumption of the trial court) grossly negligent for not having “shopped” the company before agreeing to the sale, and by not affording some of the directors adequate time to prepare for the meeting at which the sale would be considered and voted on.⁵² The Delaware supreme court held that as a consequence of not having made an informed decision, the directors would be required to prove (on remand) that the merger was entirely fair as to both price and process.⁵³

47. See generally *id.* at 870-93.

48. *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,722 (Del. Ch. Jan. 19, 1988) (gross negligence is a “high standard” requiring proof of “reckless indifference” or “gross abuse of discretion”); see also *Tomczak v. Morton Thiokol, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,327, at 96,577 (Del. Ch. Apr. 5, 1990) (citing *Allaun v. Consolidated Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929)); *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 615 (Del. Ch. 1974), *aff’d*, 316 A.2d 619 (Del. 1974).

49. No one was misled by the *Van Gorkom* court’s *de facto* application of the simple negligence review standard dressed up as “gross negligence,” as evidenced by the fact that shortly after *Van Gorkom*, the Directors’ and Officers’ (D&O) insurance industry sharply increased their premiums, and in some cases threatened to stop writing D&O insurance policies. This crisis required a legislative solution, i.e., the adoption of DEL. CODE ANN. tit. 8, §102(b)(7) (Michie 1991 & Supp. 2000) (authorizing the certificate of incorporation to exculpate directors from money damage claims premised on duty of care violations).

50. *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993).

51. See, e.g., Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 631 (2000); Bud Roth, *Entire Fairness Review for a “Pure” Breach of Duty Care: Sensible Approach or Technicolor Flop?*, 3 DEL. L. REV. 145 (2000).

52. See *Cede II*, 634 A.2d at 369-70, 371.

53. *Id.* at 371.

Again, the supreme court stated that it was applying gross negligence as the standard of review, but its description of the due care required of directors approving a sale of the corporation shows that the review standard actually being applied was far less lenient.⁵⁴ Emphasizing that it had consistently “given equal weight to the [business judgment] rule’s requirements of duty of care and duty of loyalty,” the supreme court admonished that “a director’s duty of care requires a director to take an active and direct role in the context of a sale of a company from beginning to end” and that “the directors individually and the board collectively [must] inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company.”⁵⁵

Although we support that standard as an aspirational matter, our point is that the *Cede II* court’s language does not describe “gross negligence.” Because *Van Gorkom* and *Cede II* in fact applied a standard of review that was different from gross negligence, those decisions dilute the policies served by the articulated gross negligence standard.

CEDE II AND ITS LINKAGE OF DUE CARE AND ENTIRE FAIRNESS REVIEW

Before *Cede II* was decided, duty of care and duty of loyalty claims against fiduciaries were reviewed under different standards. The difference was the threshold inquiry into whether there was a conflicting interest. Although the conflict was usually financial, theoretically the conflict could also arise from some other source. If disinterested directors exercised their independent judgment in good faith, however, the only available theory—at least before 1985—was that the directors had breached their duty of care.⁵⁶ Because the directors were not charged with any violation of loyalty, they were not required to undertake any defense until the plaintiff had shown a *prima facie* case of all of the elements for a claim for gross negligence. Thus, claimed breaches of the duty of care were essentially subjected to traditional tort analysis, i.e., whether the duty was violated, and if so, whether the violation caused harm to the corporation or the shareholders, and the burden of proof fell upon the plaintiff. If a violation of duty and resulting harm were shown, then the directors would be found liable.⁵⁷

54. *Id.* at 367-71.

55. *Cede II*, 634 A.2d at 367, 368.

56. As we have noted, this possibility was more theoretical, than real, in the area of fiduciary responsibility governed by Delaware corporation law.

57. As we have noted, the Delaware corporate law did not really enforce a separate duty of care until *Van Gorkom*, although the coming of that day was anticipated in *Graham v. Allis-Chalmers Manufacturing Co.*, 182 A.2d 328 (Del. Ch. 1962), *aff’d*, 188 A.2d 125 (Del. 1963). Nonetheless, those jurisdictions which did enforce the duty of care of corporate directors

Claimed breaches of the duty of loyalty, on the other hand, were reviewed under a far more exacting standard—entire fairness. The policy reason for applying that standard is that a board that is not conflicted is motivated to achieve the highest transaction price the market will permit. Because in those circumstances the board's interests and the interests of the shareholders are aligned, there is no reason for courts to engage in a substantive review of the board's decision. Where, however, a majority of the board is conflicted, i.e., where a majority have personal interests in the transaction that are adverse to the interest of the shareholders, it cannot be presumed that the board will be motivated to achieve the highest transaction price the market will permit. Because in such cases it is difficult to ascertain at what maximum price the transaction could have been effected in the market, the law imposes upon the directors the burden of showing that the transaction is entirely fair as to both process and price. Thus, in conflict transactions that implicate the directors' duty of loyalty, the court engages in the most searching review of the substance of the board's decision, and in close cases it resolves the doubt against the directors.

Cede II changed this clear demarcation of the standards by which duty of care and duty of loyalty claims are reviewed, to the surprise of corporate practitioners and scholars alike. It held (at least in the context of a merger or sale of the company) that if the acquired corporation's directors breach their duty of care in approving the terms of the transaction, as a theoretical matter, the plaintiff will have no burden to show that any such lapse caused injury.⁵⁸ Instead, once the plaintiff establishes an actionable lack of attention, the directors are required to establish not only that the lapse caused no injury, but also that the transaction was entirely fair both as to process and price.⁵⁹ In reaching this conclusion, the supreme court invoked the business judgment rule,⁶⁰ but without addressing the problem that its treatment of the doctrine operated to deprive corporate directors—who as a matter of policy are encouraged to be risk-takers through the use of a gross negligence standard—of the protections that ordinarily are available to defendants in garden variety tort suits—for whom the law creates incentives to act with prudent caution by setting the enforceable standard of care at mere negligence. Now the consequence of a demonstrated breach of the duty of care is to cause the

applied traditional tort burden allocation principles that corporate practitioners believed would be used by Delaware courts to govern corporate due care claims. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1136-37 (Del. Ch. 1994) (articulating the reasons the trial court had believed this proposition to be hornbook law and citing *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924), THE AMERICAN LAW INSTITUTE, 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, §§ 4.01(d), 7.18 (1994), and R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1345 (1993), in support of that contention).

58. *Cede II*, 634 A.2d at 371.

59. *Id.*

60. *Id.*

directors' conduct to be reviewed as if the directors stood accused of breaching their duty of loyalty.

The *Cede II* court cited no precedent, nor offered any explanation, for why on policy grounds duty of care claims should receive the same searching substantive review that traditionally is reserved for duty of loyalty claims. We submit that no reason in law or policy justifies that linkage.

First, the basic rationale for entire fairness review—the difficulty of ascertaining, in non-arms-length transactions, the price at which the deal would have been effected in the market—does not apply in due care cases. “Care cases, unlike loyalty cases, do not deprive corporations of ‘neutral decision-makers.’”⁶¹ In the due care context, the plaintiff should be able to identify whatever harm flowed from the neutral decision-makers’ alleged breach of care, and thereby obviate any need for judicial assessment of the substantive fairness of the board’s business decision.

Second, in care cases not involving a specific transaction, the entire fairness analysis is of little or no utility. The reason is that in non-transactional settings (e.g., uninformed or otherwise careless decisions on corporate distributions, or decisions to expand or shrink a business other than through a purchase or divestiture of an entire corporation), due care cases do not involve discrete market-based events that lend themselves to a fairness analysis. The same is true of non-transactional director conduct such as an alleged failure to monitor. Thus, the *Cede II* analytical framework is not a uniform review standard that can be applied in all breach of due care cases,⁶² which raises fundamental questions of how to locate the outer limits and contours of the *Cede II* doctrine.

Third, the *Cede II* standard-changing and burden-shifting treatment of the duty of care is procedurally unfair to directors accused of breaching that duty, and may diminish the incentive for directors to engage in risk-taking transactions that could serve the best interests of stockholders. Under traditional (pre-*Cede II*) duty of care analysis, the plaintiff had the burden of proving that the director(s) breached the duty and that the breach proximately caused harm to the corporation and/or the shareholders. Any claim that the duty was breached would be reviewed under the gross negligence standard, and if a breach of duty and resulting harm were found, then liability would follow.

Under *Cede II*, all the plaintiff need show now is a breach of the duty, irrespective of whether any harm resulted, to trigger a far more liability-threatening procedural consequence—a change of the review standard to the more exacting entire fairness scrutiny, with the directors having the burden to negate the presumption of unfairness.⁶³ Nothing in *Cede II* ex-

61. Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 822-23 (1999) (“Johnson II”).

62. *Id.* at 817.

63. As one leading Delaware lawyer and commentator has pointed out to us, *Cede II* raises

plains why directors accused of due care violations should be subjected to that far greater liability risk. The likely effect will be to make directors more risk averse, because they will have an incentive to refrain from risky wealth-creating transactions that as a policy matter corporate boards should be encouraged to undertake. Such risk aversion would run counter to the policy that gross negligence standard of review in due care cases is intended to promote.⁶⁴

The *Cede II* doctrine—that a director who breaches his duty of care will have the burden to demonstrate the entire fairness of the challenged transaction—has also resulted in another unfortunate (albeit, we venture, unintended) consequence: the rule, announced in *Emerald Partners v. Berlin*,⁶⁵ that an exculpation defense under, based on a charter provision authorized by section 102(b)(7) of the Delaware General Corporation Law, is an affirmative defense that the directors must bear the burden of establishing.⁶⁶ That burden includes negating all categories of excepted-out conduct including, most relevantly, breaches of the duty of loyalty to the corporation or its stockholders, acts or omissions that are not in good faith or involve intentional misconduct or a knowing violation of law, and transactions from which the director derived an improper personal benefit.⁶⁷

We suggest that a section 102(b)(7) defense is more properly treated as a statutory immunity than as an affirmative defense. But however the defense is treated, in our opinion it is unsound policy to impose the burden of establishing the defense on the directors. That approach undercuts the purpose of section 102(b)(7), which is to exculpate directors for duty of care claims for money damages.⁶⁸ Imposing the burden to establish the excul-

another practical problem for litigators. Because it is never clear when the *Cede II* burden-shift will occur in a particular case, and because the finding of breach may not occur until after trial, defendants must defend all due care cases as entire fairness cases.

64. Even if one were to posit that a due care violation should trigger a different review standard (a proposition with which we disagree), no rationale has been offered for choosing the entire fairness standard. If there must be a different review standard, it should be akin to the intermediate enhanced scrutiny “reasonableness” standard employed to review challenges to anti-takeover mechanisms and change of control transactions. That would entail applying a standard of review of the reasonableness of the board’s process and result. That standard of review would involve some limited review of the substance of the board decision, but would be far less intrusive than “entire fairness” review. Moreover, the reasonableness standard would at least be related qualitatively to the alleged violation of duty (breach of the duty of care).

65. 726 A.2d 1215 (Del. 1999).

66. *Id.* at 1223-34; see also DEL. CODE ANN. tit. 8, § 102 (b)(7) (Michie 1991 & Supp. 2000).

67. See *id.*

68. Veasey, *supra* note 27, at 693-94 (“One can infer from [the support of institutional investors for exculpatory charter provisions and the overall prevalence of such provisions] that the investor’s expectation is that it is fine to have directors who are risk-takers, unencumbered by concepts of tort liability for failure to do all their homework, an innocent failure to disclose material facts, or even a sustained inattention not rising to the level of bad faith. These investors want to attract good, honest, independent, business-like directors. They do not want timid, risk-averse people managing the firm.”).

pation defense upon the directors perversely requires them to disprove all of the duty of *loyalty*-related “exceptions” to the defense, to be relieved of liability for *due care* claims. That is not how the exculpation defense should work. Rather, to the extent a complaint seeks damages against directors for claimed duty of care violations, those claims should be deemed exculpated. All other claims will by definition be duty of loyalty claims that the *plaintiff* traditionally has the burden to establish. The unintended result of the *Emerald Partners* doctrine is to make those directors who interpose the exculpation defense worse off procedurally than those who do not. That creates disincentives to raising that statutory defense, as well as the potential for meritless cases to survive motions to dismiss, thereby perpetuating costly litigation having little or no countervailing social utility.

As an analytical matter, to establish the section 102(b)(7) defense, all that the defendant directors should be required to do is demonstrate the existence of the exculpatory charter provision. By doing that, the directors establish that they cannot be held liable for damages on account of any breaches of the duty of care. The logical procedural consequence would be that the plaintiff who seeks a monetary recovery against the directors will have the burden to plead facts that support the inference (and the eventual burden to prove at trial) that the directors engaged in non-exculpated conduct that resulted in damage.

Requiring directors accused of a due care violation to prove that they did not act disloyally⁶⁹ as the price for obtaining exculpation from due care damage liability implicates the same fairness and policy issues discussed earlier in connection with *Cede II*.⁷⁰ That approach also undercuts the policies sought to be achieved by the gross negligence standard of conduct that supposedly applies in due care cases.

69. We use the term “disloyally” in the broad sense of encompassing breaches of the duty of loyalty, including conduct that is in bad faith, or that constitutes intentional misconduct or results in the director receiving an improper benefit. DEL. CODE ANN. tit. 8, § 102(b)(7) (Michie 1991 & Supp. 2000).

Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or “subsidiary requirement” that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.

Emerald Partners v. Berlin, C.A. No. 9700, 2001 Del. Ch. LEXIS 20, at *87 n.63 (Del. Ch. Feb. 7, 2001) (citing *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 475 n.41 (Del. Ch. 2000)); see also *In re ML/EQ Real Estate Partnership Litig.*, Consolidated C.A. No. 15741, 2000 Del. Ch. LEXIS 238, at *4 n.2, *8 n.9, *15 n.20 (Del. Ch. Dec. 20, 1999); *Jackson Nat’l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 388 n.18 (Del. Ch. 1999) (casting doubt on the contention that “good faith” and “loyalty” are distinct fiduciary duties).

70. *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993).

**KAHN v. LYNCH COMMUNICATION SYSTEMS:
HOW MUCH DEFERENCE SHOULD BE AFFORDED
TO INTRA-CORPORATE MECHANISMS TO
ENSURE FAIRNESS?**

Before the Delaware supreme court decided *Kahn v. Lynch Communication Systems, Inc.*,⁷¹ two court of chancery decisions had split on the issue of whether the effect of an informed "majority of the minority" shareholder vote, or a vote by a special committee of disinterested directors approving an "interested" merger, would change the standard of review from entire fairness to business judgment. In *In re Trans World Airlines, Inc. Shareholders Litigation*,⁷² the court of chancery held that where a special committee operated effectively and independently, such committee approval would invoke the business judgment standard of review.⁷³ In *Citron v. E.I. Du Pont de Nemours & Co.*,⁷⁴ another judge of that same court, applying *Rosenblatt v. Getty Oil Co.*,⁷⁵ held that neither approval by a special committee of disinterested directors nor approval by an informed "majority of the minority" shareholder vote would change the standard of review.⁷⁶ Rather, entire fairness would continue to be the review standard, but the burden would shift to the plaintiff to prove that the transaction was unfair.⁷⁷

In *Lynch Communication*, the supreme court resolved the split of authority, reaffirming *Rosenblatt* and upholding the view articulated in *Citron*.⁷⁸ In so doing, however, the court unintentionally created a disincentive to seek an approving "majority of the minority" shareholder vote, because the acquired company's board can obtain the same protection by using the "special committee" device as a "cleansing" mechanism.

We submit that the time has come to reexamine *Rosenblatt* and *Lynch Communication* in two respects. Initially, we question whether there is enough utility to justify continuing the stricter scrutiny of interested mergers that are approved by one or both of these intra-corporate "cleansing processes."⁷⁹ In today's environment there is insufficient justification for giving

71. 638 A.2d 1110 (Del. 1994).

72. Civ. A. No. 9844, 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 870, 874 (Del. Ch. 1989).

73. *Id.* at *19-*22, 14 DEL. J. CORP. L. at 883.

74. 584 A.2d 490 (Del. Ch. 1990). One of the authors of this Article also authored the *Citron* opinion.

75. 493 A.2d 929 (Del. 1985). The court in *Citron* reached a different result from that reached by the Chancellor in *Trans World Airways*, not because it viewed the merits of that issue differently, but solely because it had concluded that *Rosenblatt* was binding supreme court authority mandating that different result.

76. *Citron*, 584 A.2d at 500-02 (citing *Rosenblatt*, 493 A.2d at 937).

77. *Id.*

78. See *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

79. Our analysis also extends to other types of transactions to which the *Kahn v. Lynch Communication* doctrine has been applied. See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997).

less than full cleansing effect to a self-interested merger that is conditioned on approval of a majority of the minority stockholders. That is especially true now that disclosure regulation by the Securities and Exchange Commission and the efforts of the private plaintiffs' bar are being augmented by the increased activism of institutional investors, and being facilitated by the enormous information flow made possible by new technology.

Also strained is the rationale for not giving full ratification effect to approval by a genuinely effective special committee of independent directors. As a practical matter, a judicial analysis of the special committee's effectiveness will involve a close examination of the transaction's fairness. To obtain liability-insulation from using a special committee, the directors must demonstrate that the special committee functioned in a manner such "that the controlling stockholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arm's-length.'"⁸⁰ Once a scrutinizing court concludes that the special committee operated as an effective proxy for arm's length, non-coerced bargaining, any incremental value created by an additional layer of review—allowing the plaintiff to prove that the transaction was nonetheless unfair—seems *de minimis*. Informed by a decade of experience since *Citron* was decided, we propose that the more sound approach would be for the courts to defer to the business decision reached in good faith by the elected independent directors of the corporation.⁸¹

At the very least, the burden-shifting rule of *Rosenblatt* and *Lynch Communication* should be altered in the case of self-interested mergers that are conditioned expressly on majority of the minority shareholder approval. According business judgment review treatment to mergers approved in

80. *Id.* at 429 (citation omitted); see also Veasey, *supra* note 27, at 687 ("[I]n transactions with controlling stockholders, a special committee of the board set up as a surrogate for arm's-length bargaining must be independent in operation as well as appearing on paper to be independent"); see also *Solomon v. Armstrong*, 747 A.2d 1098, 1113 (Del. Ch. 1999) (expressing same principle).

81. The approach we advocate is similar to that adopted by the Model Business Corporations Act. See Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between The Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 744 (2001) (citing MODEL BUS. CORP. ACT. ANN., §§ 8.61(b)(1)-(2), ("[a]pproval by a majority of qualified directors or disinterested shareholders fully validates the transaction and bars both equitable relief and damages")). Any lingering concern that the elimination of entire fairness review in these circumstances would deprive shareholders of needed protections is mitigated substantially by the fact that in most of the transactions subject to the *Lynch Communication* approach, shareholders would have appraisal rights. Although the appraisal remedy is not without imperfections, since *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), that remedy has frequently resulted in significant awards to appraisal petitioners. See, e.g., *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 526 (Del. 1999) (affirming \$85 per share appraisal award versus \$41 per share merger price); *Rapid-American Corp. v. Harris*, 603 A.2d 796, 804 (Del. 1992) (affirming \$51 per share appraisal award versus \$28 per share merger price); *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1146 (Del. 1989) (affirming \$347,000 appraisal award versus \$94,000 merger price).

that manner would create an incentive for acquired company boards and management to vest the decisionmaking power over the transaction's procession in the disinterested members of the corporate electorate.

We recognize that the integrity of the special disinterested director committee process remains subject to debate. The argument against according that process business judgment review is that although most public company boards have a majority of independent directors, those directors are not hermetically sealed off from the inside directors. It is commonplace for outside directors to have social, and in some cases business, relationships (e.g., a partner in the company's outside law firm or investment bank serving as a director). That reality may explain the Delaware supreme court's reluctance to give the special committee device full credit as a cleansing mechanism. It may also provide a basis for withholding full ratification effect to board approval of transactions achieved in that fashion.

Majority of the minority shareholder approval, on the other hand, stands on a different footing, because by definition minority stockholders are not conflicted and their approval of an interested merger could not be challenged on that ground. The only basis to challenge the integrity of such a stockholder vote is by attacking the sufficiency of the proxy disclosures or by showing that the vote was coerced. If the disclosures were faulty or the voters were coerced, then the shareholder vote should create no standard-of-review-changing benefit. If, however, the vote is uncoerced and is fully informed, there is no reason why the shareholder vote should not be given that effect, particularly given the supreme court's rightful emphasis on the importance of the shareholder franchise and its exercise.⁸² Under current law, however, entire fairness remains the standard of review, and the only benefit of majority of the minority stockholder approval is to shift the burden of proof (to show unfairness) to the plaintiffs.

Citron and *Lynch Communication* base that result on a concern that even a fully informed disinterested shareholder approving vote may be coerced, because the minority could be intimidated by the perceived, implicit threat of possible retribution by the interested majority stockholder if the minority votes against the proposed transaction.⁸³ In our opinion, experience has shown that that concern is too insubstantial to justify a review standard that requires judges to second-guess a business transaction that rational investors have approved. Delaware case law is replete with cases where majority stockholders have been held legally accountable for abusing the minority. There is no empirical basis for courts to presume conclusively—as our current rule does—that the threat of liability would not, in most

82. See, e.g., *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135 (Del. 1997); *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319 (Del. 1993); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977).

83. See *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990); see also *Kahn v. Lynch Communication Sys., Inc.* 638 A.2d 1110, 1116-17 (Del. 1994).

cases, check majority stockholder misconduct that is reactive to a disapproving minority stockholder vote.

Because the standard of review presently gives no greater effect to conditioning a transaction on an informed majority of the minority vote than it does to approval by an effective committee of independent directors, there is little incentive for controlling stockholders to use the stockholder vote mechanism as a protective device. The better policy, we think, is to afford business judgment review treatment to self-interested mergers that are approved by either an effective independent director committee or by a majority of the minority stockholder vote. At a minimum, that treatment should be afforded to approval by an informed “majority of the minority” of the shareholders.

UNOCAL’S AND UNITRIN’S LINKAGE OF THE BUSINESS JUDGMENT, INTERMEDIATE “REASONABLENESS,” AND ENTIRE FAIRNESS STANDARDS OF REVIEW

Also in need of mid-course correction are Delaware’s intermediate or “enhanced scrutiny” standards of review. The first of the several intermediate standards, originally announced in *Unocal*,⁸⁴ involves judicial scrutiny of the reasonableness of a target company board’s defensive measures. Under *Unocal*, where a target company board adopts antitakeover defensive measures, the board has the burden to establish that (i) it reasonably perceived that the unsolicited takeover bid was a threat to corporate effectiveness and policy, and (ii) the defensive measure adopted was reasonable in response to the threat.⁸⁵ The second step of the *Unocal* analysis, as elaborated ten years later in *Unitrin*,⁸⁶ provides that a defensive measure will be found disproportionate (i.e., an unreasonable response in relation to the threat) if it is either draconian (coercive or preclusive) or falls outside a range of reasonable responses.⁸⁷ That analytical framework did much to advance the quality and predictability of judicial review in this area, and we do not quarrel with its basic thrust.

But one aspect of the *Unocal* and *Unitrin* cases is problematic: their linkage of the intermediate scrutiny reasonableness review standard to both the business judgment and the entire fairness standards of review.⁸⁸ Those

84. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

85. *Id.* at 954-55.

86. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

87. *See id.* at 1367.

88. This original linkage may have been influenced by the supreme court’s desire that corporate constituencies view the new *Unocal* standard as a reasoned diminution of deference that still afforded well-intentioned directors substantial room to operate. Although *Unocal* drew its inspiration from the standard used in *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964), the articulation of the new intermediate scrutiny standards in *Unocal* and *Revlon* were perceived in 1985 and 1986 as quite significant and arguably novel. Because of *Unitrin* and the benefit

cases hold that (i) if the board satisfies the *Unocal* reasonableness standard, its defensive actions are then subject to review under the business judgment standard, and (ii) if the board's actions fail to pass muster under *Unocal*, the defensive measures will be invalidated unless the board can demonstrate that its actions were entirely fair.⁸⁹ In this manner, the business judgment, intermediate reasonableness, and entire fairness standards of review become linked together as part of a continuum in cases where board conduct is reviewable under the *Unocal* standard.

The linkage operates as follows: if upon applying *Unocal* the court finds that the defendant directors have met their burden of demonstrating the substantive reasonableness of their actions, the court must then proceed to a second analytical step—applying the “normal” business judgment review standard.⁹⁰ However laudable may be the motivation for that linkage (doctrinal unification and simplification), that approach creates unnecessary layers of judicial review of board action that is better and more efficiently reviewed under a single standard—reasonableness.⁹¹

Two analytical difficulties exist with the current linked-standard approach. The first is that the business judgment rule exists primarily to prevent a board's business decisions from being judicially scrutinized for their substantive reasonableness—an event that under *Unocal* will already have occurred.⁹² The second is that the business judgment layer of review requires the plaintiff to show that the board's decision was the invalid product of a breach of either the directors' duty of loyalty or care. It is difficult to imagine how a plaintiff could ever make that showing where the board was already found under *Unocal* to have met its burden of showing that its actions were reasonable.⁹³

The second problem infects the opposite end of the *Unocal/Unitrin* linkage—the holding that a board that fails to meet its *Unocal* burden may still prevail by demonstrating that its actions satisfied the entire fairness standard.⁹⁴ Although one scenario might (theoretically) be imagined where

of over a decade's worth of experience with intermediate standards, this linguistic comfort is no longer needed, nor is it worth the inefficiencies and confusion it creates.

89. See *Unitrin*, 651 A.2d at 1377 n.18 & 1390; see also *Unocal*, 493 A.2d at 958.

90. See *Unitrin*, 651 A.2d at 1390 (quoting *Unocal*, 493 A.2d at 958).

91. *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 473-77 (Del. Ch. 2000).

92. See *id.* at 475.

93. See *id.* at 475-76. It is hard to fathom how the plaintiff could rebut the business judgment rule presumption of due care by demonstrating that the board acted in a grossly negligent manner, or (assuming that the presumption cannot be rebutted) by demonstrating that the board's action had no “rational business purpose,” where its actions have already been found to be reasonable. Similarly, to the extent the plaintiff has evidence of disloyalty sufficient to rebut the business judgment rule presumption that the board acted loyally, that evidence would likely be fatal to, and preclude, a finding that the board's actions satisfied *Unocal* to begin with. See *id.*

94. *Id.* at 476 (citing *Unitrin*, 651 A.2d at 1377 n.18).

that linkage could work,⁹⁵ in cases where the board failed to demonstrate that its defensive measures were reasonable and not draconian, it seems highly unlikely that the board could show that those measures were, nonetheless, “fair.”

We propose, for these reasons, that once the target company board’s defensive actions are found to satisfy or fail the *Unocal* test, any further judicial review of those actions under the business judgment or entire fairness standards is analytically and functionally unnecessary. Judicial review under *Unocal/Unitrin* should stand on its own, “decoupled” from “second step” review under those other two review standards.

BLASIUS AND THE TENDENCY TO MULTIPLY STANDARDS OF REVIEW

Our effort to simplify the structure of judicial review of corporate fiduciary conduct requires us to identify what elements are most fundamental in each distinctive context where review occurs. That analysis prompts us to conclude that the relationship between the *Blasius*⁹⁶ and the *Unocal/Unitrin* doctrines is a fruitful subject for some doctrinal pruning.

Our desire to simplify the review structure does not stem from a policy disagreement with the primacy *Blasius* accords to the shareholder franchise. Indeed, the shareholders’ right to elect the corporation’s governing body is a fundamental, cardinal foundation of Delaware corporation law. When directors intentionally act to thwart the right of the shareholders to remove them at the polls, they intrude upon basic statutory rights of the shareholders and upset the careful balance of power created by the Delaware General Corporation Law. As *Blasius* recognized, where directors purposely intrude on the shareholders’ right to select a new board, the directors are not exercising an ordinary business judgment. Rather, their actions threaten to undermine the statutory allocation of power upon which the legitimacy of the corporate form is based.⁹⁷ As thus viewed, *Blasius* reaffirmed the traditional view that director actions primarily motivated

95. As described in *In re Gaylor Container*, a scenario could be posited in which the board, without first conducting any “threat” analysis, adopts defensive measures that turn out to be “reasonable,” i.e., not disproportionate to the threat (again, as found after-the-fact by the court). *Id.* at 476. Under current doctrine, the court would most likely be required to find that the board failed to pass muster under *Unocal* (because it failed to conduct the first analytical step), yet would uphold the defensive measure anyway under the entire fairness test. But, as *In re Gaylor Container* suggests, that scenario would not arise if the *Unocal* reasonableness test were not viewed as a rigid two-part analysis but, rather, as a unitary examination of whether the directors’ actions, taken as a whole, were reasonable. *Id.* at 476, n.46. In the concluding section of this Article, we propose that the *Unocal/Unitrin* analysis be so modified to eliminate this “outlier” scenario.

96. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

97. *See id.* at 660.

to effect a disenfranchisement have a dim chance of being sustained.⁹⁸

The problem with the *Blasius* standard of review is one of practicality, not principle. As later interpreted and applied in various cases, the *Blasius* doctrine evolved into a flexible standard that functionally looks very much like the *Unocal/Unitrin* standard, but with a strong emphasis on the importance of the franchise. The post-*Blasius* experience has shown that presentations to the court were not made clearer, nor were helpful analytical solutions suggested, by the addition of a *Blasius* argument to a brief that already included a *Unocal* argument. The reason is that after *Unitrin*, it is difficult to unearth or even imagine a case that would be decided differently if the analysis were conducted under the *Blasius* rather than the *Unocal* standard. Because the purpose underlying the *Blasius* standard is furthered equally well by another, more easily applied, standard, *Blasius* should be eliminated as a “stand-alone” review doctrine.

To elaborate, before *Blasius*, there were two “intermediate” standards of review: *Unocal* and *Revlon*. *Blasius* and its progeny, building upon *Schnell v. Chris Craft Industries, Inc.*,⁹⁹ appeared to add a third, namely, that board action taken “for the primary purpose of thwarting the exercise of a shareholder vote,” even if done in subjective good faith, will not be upheld unless the board can show a “compelling justification” for its action.¹⁰⁰ As earlier noted, that standard was grounded upon the fundamental importance of the shareholder franchise as the underpinning—and source—of the board’s legitimacy under Delaware law. The *Blasius* “compelling jus-

98. *Id.* (citing cases such as *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769 (Del. Ch. 1967) and *Canada Southern Oils, Ltd. v. Manabi Exploration Co.*, 96 A.2d 810 (Del. Ch. 1953) in support of its strong protection of the shareholder franchise).

99. 285 A.2d 437 (Del. 1971). *Blasius* drew inspiration from the *Schnell* doctrine that action by fiduciaries, even if lawful, could be improper if it was inequitable. In *Blasius* itself, the court did not invoke *Schnell* directly, apparently because it found that the defendants who had the intent of thwarting the election of a new majority had acted in subjective, good faith. See *Blasius*, 564 A.2d at 658 (noting that if the directors were acting in bad faith, their actions would have been in breach, per *Schnell*). The court therefore carefully analyzed the directors’ arguments in the context of the power arrangements established by the Delaware General Corporation Law. Given the fundamental statutory policy that the electorate selects the board, the court concluded that however well-intentioned it may be, a board can not purposely undermine the stockholders’ statutory right to exercise the franchise without a compelling justification. See *id.* at 658-63. A system of corporate democracy—like a system of republican democracy—cannot be sustained if the incumbents can halt the electoral process whenever they believe in good faith that the electorate will be making a mistake by replacing them. *Blasius* recognized this reality and subjected director action of that kind to the most searching scrutiny.

The court aligned *Blasius* more directly with *Schnell* in a later case, where it recognized that even subjectively well-motivated action that has the intended effect of undermining statutory voting rights is inequitable. See *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1122 (Del. Ch. 1990).

100. See *Blasius*, 564 A.2d at 660-63.

tification” requirement was a ringing endorsement of the need to afford maximum protection to the shareholders’ right to vote for directors, against any interference with their right by the directors themselves.

Post-*Blasius* case law experience, however, exposed analytical difficulties in determining the proper scope of the “compelling justification” test. These difficulties arose principally for two reasons.

First, the most difficult judicial task became how to determine the predicate to the application of *Blasius*. That is, how could the court identify whether (i) the directors had acted with the “primary purpose” of disenfranchisement that invokes the compelling justification test or whether (ii) the directors had simply exercised their legitimate discretion as to how and when corporate elections would be conducted. The threshold issue of whether the directors had acted in a manner that triggered *Blasius* was crucial, given the onerous burden imposed by *Blasius* and the fact that that standard, when applied, is often outcome-determinative.¹⁰¹ The problem was that *Blasius* itself gave no guidance to judges charged with determining whether the directors had acted with the requisite disenfranchising intent.¹⁰²

Second, the fact patterns that (potentially) implicated *Blasius* tended also to implicate *Unocal*, because the (alleged) franchise-thwarting action under attack also amounted to a defensive measure designed to block or impede an unsolicited hostile bid. The result was unintended competition between these two standards of review, and required the court to choose between them.¹⁰³

The confluence of these two factors led judges to a practical approach that was heavily reliant on *Unocal*. Although the *Blasius* and the *Unocal* analyses originated in somewhat different contexts—proxy contests and hostile tender offers—in practice those contexts often overlapped because hostile take-over attempts often could not be successfully pursued (particularly after *Paramount Communications, Inc. v. Time, Inc.*¹⁰⁴ (*Time-Warner*)) without a proxy contest to elect a new board. Replacing the board became an essential part of a hostile offeror’s strategy, because that was the only way to circumvent the otherwise preclusive effect of the poison pill that the incumbent target board would typically refuse to redeem.¹⁰⁵ Further-

101. See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293, 319-20 (Del. Ch. 2000).

102. In *Blasius*, the directors admitted that they had acted to thwart the election of a new board majority.

103. As *Chesapeake* pointed out, both the Delaware supreme court and the court of chancery have recognized the high degree of overlap between the concerns animating the *Blasius* and the *Unocal* standards of review. *Chesapeake*, 771 A.2d at 320 (citing and quoting *Stroud v. Grace*, 606 A.2d 75, 82, 92, and n.3 (Del. 1992)). Cases where the court of chancery had to choose between the two standards include *Golden Cycle, LLC v. Allan*, C.A. No. 16301, 1998 Del. Ch. LEXIS 80 (Del. Ch. May 20, 1998), *Kidsco Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch. 1995), and *Stahl*, 579 A.2d 1115.

104. 571 A.2d 1140 (Del. 1990).

105. See, e.g., *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1193-94 (Del. Ch. 1998).

more, the post-*Blasius* decisions surfaced the reality that a sorting mechanism was needed to insulate from the severe “compelling justification” test, situations where directors took direct action to influence the electoral process, but in a manner that was consistent with their legitimate authority.¹⁰⁶

Unocal, rather than *Blasius*, provided the more attractive vehicle for judicial review in those latter circumstances. The *Unocal* standard requires the directors to establish the corporate objectives their actions were intended to serve, and requires the court to examine the objective effects of the directors’ actions. Specifically, *Unocal*—as refined by *Unitrin*—requires the court to decide whether any “defensive measure” (such as any attempt to manipulate a vote presumably is) is preclusive or coercive. The elements of the *Unocal/Unitrin* analysis therefore gave courts the tool to answer the predicate question to the application of *Blasius*—did the directors act with the primary purpose of disenfranchisement? *Blasius*, on the other hand, contained no such analytical guideline to help the court decide that threshold issue.

That this practical convergence of the two standards began to emerge should, in retrospect, not be surprising. In application, the “preclusiveness” or “coerciveness” inquiry under *Unocal/Unitrin* and the inquiry into the board’s “primary purpose” under *Blasius*, are not easily separable. Even the demanding *Blasius* standard did not preclude all board actions that had the effect of delaying a vote in all circumstances.¹⁰⁷ The line between board actions that influence the election process *legitimately* (e.g., delaying the election to provide more time for deliberations or to give the target board reasonable breathing room to identify alternatives) and board action that *illegitimately* delays or impedes the exercise of the stockholder franchise is rarely bright.¹⁰⁸

106. *Williams v. Geier*, 671 A.2d 1368 (Del. 1996) contains a remarkably candid admission of this fact: “*Blasius*’ burden of demonstrating a ‘compelling justification’ is quite onerous, and is therefore applied rarely.” *Id.* at 1376 (emphasis added).

107. See *Golden Cycle*, 1998 Del. Ch. LEXIS 80 (holding where the target board’s decision to set an early and unannounced record date disenfranchised some holders and created confusion among others but would not preclude nor substantially interfere with a stockholder-bidder’s consent solicitation to remove the target board, *Blasius* review was unwarranted); *H.F. Ahmanson & Co. v. Great W. Fin. Corp.*, C.A. No. 15650, 1997 Del. Ch. LEXIS 84, at *56 (Del. Ch. June 3, 1997) (stating that a delay of fifty days in holding meeting did not “impede the effective exercise” of franchise and therefore did not trigger *Blasius*; for same reason, delay was not “preclusive nor coercive” under *Unocal*); *Kidsco*, 674 A.2d at 495-96 (bylaw amendment ensuring that stockholders could vote on a merger agreement 25 days before bidder could call a stockholder-initiated meeting in connection with tender offer was not subject to *Blasius* because it was not preclusive and simply gave the stockholders the opportunity to consider the merger free from the confusion of a simultaneous electoral contest); *Stahl*, 579 A.2d at 1123 (ruling when a change in the company’s planned but not set meeting date did not preclude a fair directors’ election, *Blasius* review was not applicable).

108. Indeed, absent confessions of improper purpose, the only reliable evidence of the purpose is often the objective effect of the board’s action. See *Williams*, 671 A.2d at 1376.

Once it was established that the law would credit the board's justification for *some* actions that had the effect of delaying or arguably "impeding" the vote, the structure of the *Blasius* analysis came to resemble very closely the structure of the *Unocal* analysis—albeit with a different interpretative flavor. In both contexts the analysis was pragmatic. What is the effect of the board's action and what is its justification? The interpretive flavor is, however, also important. *Unocal*, with its enhanced business judgment language proved to be rather management friendly,¹⁰⁹ whereas the noninterference-with-the-franchise tone of *Blasius* was undeniably less management friendly.¹¹⁰

But the question for us is whether that "flavoring" difference justifies the added doctrinal complexity created by continuing *Blasius* as a separate review standard. In the current legal environment, where courts have shown their readiness to protect the integrity of the voting process under the *Unocal/Unitrin* structure, the Delaware courts have indicated that the answer should be no.¹¹¹

109. In *City Capital Associates LP v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988), the court of chancery applied *Unocal* as a rigorous standard that protected stockholder choice in the tender offer context. *Interco*, in essence, held that a board could not use a poison pill to prevent indefinitely the stockholders from considering a fully-financed, all shares, cash tender offer. *Id.* at 790. Rather, the board could use the pill only to delay that consideration to develop a superior deal or to facilitate communications that would help stockholders make an informed decision whether to tender. *Id.* In *Time-Warner*—which did not involve a board's use of preclusive defensive devices—the Delaware supreme court in *dictum* criticized the analytical approach the court of chancery had taken in *Interco* and other cases. See *Paramount Communications, Inc. v. Time Inc. (Time-Warner)*, 571 A.2d 1140, 1153 (Del. 1990). Although the supreme court's *dictum* was unclear, it did convey the clear message that the supreme court believed less stringent review was appropriate. The *Time-Warner* court, however, did not articulate a new doctrine to replace *Interco*.

110. See *Stahl v. Apple Bancorp, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,412 at 97,031 (Del. Ch. Aug. 9, 1990):

As the earlier opinion in this case relating to the calling of the annual meeting tried to show, [the *Unocal* and *Blasius*] tests are structurally similar and may, as there, be functionally similar as well.

Under either test the board bears a burden to justify its actions. The burden will be greater when the board action is directed specifically and primarily towards the voting process, because that process is the way in which the board itself derives power and thus is of central concern to the corporation and to the corporation law.

Id. at 97,036.

111. One essential caveat is noted. A core concept underlying *Blasius* is that a threat that the shareholders are about to make an ill-advised choice in an election (or in that case, a consent contest) does not itself represent a "threat" sufficient to justify an action intended to affect the vote. But, the *Time-Warner* case established that under *Unocal*, "substantive coercion"—the name used to describe the "threat" that shareholders may disbelieve management's reasons for opposing an unsolicited bid—does constitute a threat the board may reasonably defend against. Our willingness to fold *Blasius* into *Unocal* does not take us so far

Since the early 1990s, the court of chancery and the Delaware supreme court began gradually to “fold” the *Blasius* standard into *Unocal*, effectively making the former a subset of the latter. The first step in that process was *Stroud v. Grace*,¹¹² where the supreme court held that *Unocal* must be applied to any defensive measure touching upon issues of control, even if that measure implicates voting rights.¹¹³ *Stroud* emphasized that “[a] board’s unilateral decision to adopt a defensive measure touching ‘upon issues of control’ that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a ‘compelling justification.’”¹¹⁴ The second step of the effort to unify these two standards was *Unitrin*, which emphasized the interrelationship between those standards where at issue was the propriety of the target board’s defensive measures against a tender offer coupled with a proxy contest to replace the incumbent board.¹¹⁵ Unfortunately, neither *Stroud* nor *Unitrin* answered the question of whether the *Blasius* compelling justification test must always be used within the *Unocal/Unitrin* analytical framework, or whether in some circumstances *Blasius* can or should be used as a free-standing standard of review.

The fine analytical distinctions required by having parallel, coexisting standards of review that are similar in operation and result strike us as functionally unhelpful and unnecessary. The post-*Blasius* experience has shown that the *Unocal/Unitrin* analytical framework is fully adequate to capture the voting franchise concerns that animated *Blasius*, so long as the court applies *Unocal* “with a gimlet eye out for inequitably motivated electoral manipulations or for subjectively well-intentioned board action that has preclusive or coercive effects.”¹¹⁶ Accordingly, we submit that the supreme court should square the circle and complete the doctrinal unification of *Blasius* and *Unocal*, by declaring that henceforth the analysis required by *Unocal*, as elaborated by *Unitrin*, will be used to analyze cases involving a board’s interference with the shareholder vote as part of its resistance to a hostile takeover or board election contest.

to recommend the notion of importing the “substantive coercion” concept of justification into voting law. There may be many reasons—mostly associated with timing and information issue—that might under *Unocal* justify acts intended to influence the shareholders voting process. But the fact that the shareholders may not agree with management respecting “who should sit on the board” certainly cannot count as any reason to support “defensive” corporate action. We reiterate that our recommendation that voting issues be reviewed under *Unocal* rests on the assumption that courts will apply that test with rigor and that the doctrine of *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971), retains vitality.

112. 606 A.2d 75 (Del. 1992).

113. *Id.* at 82.

114. *Id.* at 92 n.3 (quoting *In re Time Inc. Shareholder Litig.*, C.A. No. 10670, 1989 WL 79880 (Del. Ch. July 14, 1989)).

115. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1379-80 (Del. 1995).

116. *Chesapeake Corp. v. Shore*, 771 A.2d 293, 323 (Del. Ch. 2000).

CONCLUSION: REWORKING THE STANDARD-OF-REVIEW MAP

The thrust of the foregoing analysis is simply this: corporate law cases should be reviewed functionally by using three basic standards that embody the fundamental policies underlying Delaware's approach to corporation law, while providing a cleaner, simpler prism through which to evaluate specific corporate disputes.

The first would be the traditional entire fairness and business judgment review standards, but with some modifications. Under our suggested approach, the focus would be upon whether the directors breached their duty of loyalty. Where the challenged transaction involves self-dealing, the directors would have to demonstrate the fairness of the transaction, unless the defendants have used one of the protective approval mechanisms set forth in section 144 of the Delaware General Corporation Law.¹¹⁷ In contrast to current practice, however, we would apply the business judgment review standard to self-interested mergers, in cases where the merger: (i) was expressly conditioned on an informed and uncoerced majority of the minority vote; or (ii) was approved as fair by an effective and uncoerced special committee of independent directors.¹¹⁸ At the very least, we would deviate from the current approach in cases where the "cleansing" mechanism is a fully-informed vote of a majority of the minority stockholders, by giving such a vote the effect of insulating the transaction from judicial invalidation. The deference this standard of review embodies would provide an incentive for majority stockholders to give minority stockholders veto power over self-interested transactions.

We would also rid the corporate law of the "waste" exception to the ratification effect currently accorded to informed, uncoerced stockholder votes.¹¹⁹ Under present Delaware law, a fully informed majority vote *of the disinterested stockholders* that approves a transaction (other than a merger with

117. DEL. CODE ANN. tit. 8, § 144 (a). We recognize that section 144 applies, as a technical matter, only to the question of whether a conflict transaction is automatically voidable. As a matter of common law fiduciary doctrine, however, the protective devices set forth in that statute are also relevant to determining whether the business judgment or entire fairness standard governs the review of a particular transaction.

118. This change will also respond in part to the criticism of those who contend that Delaware corporate law is excessively indeterminate and permits too much room for litigation. See, e.g., Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. (forthcoming in 2001); Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887 (1999). It would also help clarify Delaware's law of ratification. See *Solomon v. Armstrong*, 747 A.2d 1098, 1113-14 (Del. Ch. 1999) (stating that "Delaware's law concerning the effect of shareholder ratification in the face of an alleged breach is not a model of clarity").

119. See, e.g., *In re Wheelabrator Tech., Inc. Shareholders Litig.*, 663 A.2d 1194, 1203 (Del. Ch. 1995) (discussing exception); *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979) (stating exception).

a controlling stockholder) has the effect of insulating the directors from all claims except waste. The waste exception, which is a vestige of a long-gone era of corporation law, has no present-day utility.¹²⁰ When fully informed, disinterested stockholders have approved a transaction, on what principled basis could a court determine that the transaction is wasteful? The waste standard turns on whether a reasonable person could believe that the transaction was supported by adequate consideration. A judicial determination that a transaction affirmed by informed, disinterested stockholders constituted waste would amount to a conclusion that the corporate electorate had acted bizarrely.¹²¹ Unsurprisingly, no Delaware case of which we are aware has ever held that a properly ratified transaction constituted waste. Eliminating the waste “vestige” will have the same functional utility as our proposal to eliminate the “second layer” of review under the business judgment (or entire fairness) standards in cases where an antitakeover defense measure has already been found to pass or fail *Unocal/Unitrin*.¹²²

The business judgment (and entire fairness) standards warrant one additional refinement: an explicit acknowledgment of the difference between (i) the judicial inquiry that will suffice to determine that a transaction is unfair and should be enjoined or rescinded, and (ii) the inquiry that is required to impose monetary damages liability for an unfair transaction that cannot be enjoined or rescinded. In cases where the transaction cannot be undone, the court must conduct a director-by-director inquiry into which specific directors actually engaged in a breach of fiduciary duty sufficient to justify monetary liability. The fact that a transaction is found to be “unfair” does not necessarily mean that all the directors have the same exposure to liability. Where the corporation has a charter provision that exculpates directors from monetary liability for breaching their duty of care, the plaintiff must establish that a director who had no conflicting self-interest in the transaction nonetheless acted in bad faith. If a director did not benefit from the unfair transaction, the plaintiff who seeks to subject that director to money damages liability should have the burden to prove that the director consciously breached his duties to the corporation.

The second basic standard of review would govern claims that the directors breached their duty of care. That standard should be straightforward and direct: did the plaintiff prove that the board’s conduct was

120. See, e.g., *Criden v. Steinberg*, C.A. No. 17082, 2000 Del. Ch. LEXIS 50, at *9-*15 (Del. Ch. March 23, 2000); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 895-902 (Del. Ch. 1999).

121. See *Huizenga*, 751 A.2d at 901. Cf. *Veasey*, *supra* note 27, at 694 (one of the expectations investors have of courts is that judicial decisions will “properly limit the function of the court”).

122. This move will also reduce room for unnecessary litigation. See *supra* text accompanying note 118.

grossly negligent *and* caused injury?¹²³ If so, then in the absence of an exculpatory charter provision, liability should follow. Otherwise, there should be no liability.

The current *Cede II* approach of requiring that directors who acted without due care must prove that they did not cause injury, runs counter to the public policy that animates the gross negligence standard of review. That policy reflects the concern that directors will be too inhibited in their decision making if they risk being held liable for decisions that involve ordinary negligence. By subsuming the duty of care into the duty of loyalty, *Cede II* undercuts that policy. No discernible reason has been advanced for relieving the plaintiff from the burden of proving that the directors' grossly negligent acts caused quantifiable harm. Similarly, when seeking damages from directors of a corporation that has an exculpatory charter provision, the plaintiff should be required to plead a duty of loyalty violation.¹²⁴ This reallocation of burdens, and the de-coupling of the duty of care from the duty of loyalty, will better implement the public policy values inherent in the gross negligence standard and reflected in section 102(b)(7).¹²⁵

The third standard of review would be a modified version of the *Unocal/Unitrin* "reasonableness" analysis. *Unocal's* original rationale for creating the intermediate standard of review was sound.¹²⁶ That intermediate standard operates at the intersection between the directors' authority to manage the corporation and the stockholders' rights and powers as owners of property. Where directors take actions that impede the ability of the owners of the enterprise to sell their shares or elect a new board of directors, those actions raise fundamental issues of legitimacy, which makes it appropriate to employ a more searching and flexible form of judicial review to assess the validity of the board's action.

The intermediate standard that we propose would govern all objectively defensive actions taken by boards of directors. In contrast to the current law, which links the *Unocal* standard to the business judgment rule, we urge that the *Unocal* standard be free-standing. Because the public policy that underlies the business judgment standard is already adequately reflected in the deferential *Unocal/Unitrin* analytical approach, the linkage between the two standards results in a largely meaningless second step that adds little value.

We also would alter the current "reasonableness" standard slightly, by retaining the existing two-step test as part of a broader, unitary inquiry into whether the board-adopted defensive measures taken as a whole, were

123. Cf. MODEL BUS. CORP. ACT. ANN. § 8.31 (providing that the plaintiff has the ultimate burden of persuasion to prove breach and damages).

124. We believe that the duty of loyalty is breached if any of the exceptions to § 102(b)(7) apply. See *supra* text accompanying notes 65-67.

125. DEL. CODE ANN. tit. 8, § 102(b)(7) (Michie 1991 & Supp. 2000).

126. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).

reasonable in light of the objective circumstances facing the board.¹²⁷ Under that approach, a board's failure to pass the "threat" prong of the *Unocal* analysis would not automatically doom a defensive measure to invalidation. This more flexible analytical framework would enable a board action to pass muster under *Unocal*, even if the board failed to conduct a sufficient "threat" analysis. The primary virtue of our suggested approach is that it avoids the need for a wholly new second-step inquiry into whether a less-than-optimally informed board nonetheless acted "fairly."¹²⁸

In all other respects, the current *Unocal/Unitrin* standard would remain unchanged. That standard's focus on preclusion and coercion is functionally useful and should be retained. That framework will also give courts the tools to protect stockholders adequately against board decisions that threaten the stockholders' ability to exercise their right to influence corporate policy at the ballot box. For that reason, *Blasius*-type claims would be evaluated under this standard as well, *trusting the courts to recognize that there are fundamental limitations on the power of corporate directors to impair the ability of the governed to remove them at the polls.*¹²⁹

As with our proposed business judgment rule/entire fairness standard, this modified *Unocal* standard would function differently depending on whether the court is being asked to enjoin defensive measures or to award monetary damages. In the former case, the defensive actions would be enjoined if the measures were found to be unreasonable. In the latter case, that showing would not be enough. Rather, the plaintiff would have to establish a director-by-director case for damages, consistent with the public policy that confines director liability for damages primarily to situations where the directors benefit from self-interested transactions or consciously breach their fiduciary duties.

Finally, our modified intermediate standard would recognize more fully the premise that is implicit in the so-called *Revlon* standard, namely, that the fiduciary duties of directors will vary depending on the circumstances they confront. Where directors have decided to commit the corporation

127. Cf. THE AMERICAN LAW INSTITUTE, 1 CORPORATE GOVERNANCE PRINCIPLES, § 6.02, cmt. a (1994) (recommending that the plaintiffs have the burden to prove that defensive measures were unreasonable in view of all the circumstances facing the corporation).

128. We are aware of only one case in which Delaware courts have been required to undertake such an analysis. See *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 271 (Del. Ch. 1989).

129. Parenthetically, we also submit that our intermediate standard need not be supplemented by a separate and distinct test for termination fees in merger agreements that are labeled as "liquidated damages" provisions. Although we do not quibble with the sound reasoning underlying *Brazen v. Bell Atlantic Corp.*, 695 A.2d 43 (Del. 1997), the case applied a mode of reasoning that is fully consistent with the intermediate standard that we articulate, as the decision itself acknowledges. See *id.* at 49. Any increased precision gained from applying a "liquidated damages" mode of analysis is, in our view, outweighed by the costs of unnecessarily proliferating the standards of review by which identical forms of board action are evaluated.

to a change of control transaction, their actions must be evaluated solely by reference to their duty to obtain the highest value reasonably available. That standard is less flexible than that applied by courts outside the *Revlon* context. In cases where the *Revlon* doctrine is not implicated, a board may justify its defensive actions by reference to a much broader range of corporate objectives.¹³⁰

Except for requiring the court to evaluate the reasonableness of the directors' action against the singular objective of current value maximization, the *Revlon* standard differs little from the *Unocal* standard in practical application. Delaware courts accord directors the discretion to seek the best price by a variety of methods, including single-bidder negotiations supplemented by an effective market check.¹³¹ In *Revlon* cases where the board is not accused of discriminating among bidders, the outcome normally will depend on whether the board's defensive measures were reasonable in view of the directors' decision to sell the business and their concomitant obligation to obtain the best price.

We submit these proposed standards of review, taken together, will provide a functional basis for deciding most corporate fiduciary cases while shearing off some inefficient embellishments that have developed over the years. By reducing the number of standards, our approach also places the emphasis where it ought to be—upon whether directors have fulfilled their fiduciary duties in specific circumstances. By distinguishing between the showing that suffices to support an injunction (or rescission) and the showing required to support a damages award against specific directors, the standards would explicitly surface and balance two competing public policy interests—the interest in making remedies available for unfair corporate conduct, and the interest in avoiding damage awards that could discourage directors from engaging in economically useful risk-taking. Lastly, by giving greater liability-insulating effect to fully informed stockholders votes and approvals by effective special committees, our proposed standards will provide an incentive for corporate boards to use these protective mechanisms, and will minimize judicial second-guessing of transactions whose integrity is adequately ensured by intra-corporate procedures.

The approach we propose recognizes, and is inspired by, the valued and creative accomplishments of the Delaware courts during an unprecedented era of rapid doctrinal change. We seek to capture and retain what was most valuable from that important era, while modifying only those approaches that have proved to have less utility. These modest incremental changes should better position the Delaware corporation law to tackle the new doctrinal challenges that will undoubtedly emerge during this new century.

130. We recognize that this makes the question “what constitutes a change of control transaction?” important, and that much work remains to be done in helping the bar answer the question.

131. See *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286-87 (Del. 1989).