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Decisional Integrity and the Business Judgment Rule: A Theory

Alfred Dennis Mathewson*

I. INTRODUCTION

Shareholders associate together to own a business enterprise in corporate form. The nature of this association requires that an individual shareholder accept less than exclusive control over the enterprise and live with some form of collective decision making. In fact, corporate law divests shareholders of direct decision-making power and, instead, vests it in a board of directors elected by shareholders. Despite this divestiture, shareholders voluntarily step into these associations in the hope of obtaining a share in the enterprise's profits.

Making a profit necessarily requires the board of directors to take some risks. Thus, shareholders must expect that directors, to whom decision-making authority has been delegated, will take risks in the pursuit of profits and that some activities undertaken will fail.¹ The expectation that some pursuits will fail, combined with the mandatory delegation of decision-making authority, often leads to dissention among the investors regarding the particular risks undertaken and disappointment in the profit on their returns. Corporate law generally permits these dissenting and disappointed shareholders to sell their shares, or to attempt to influence the election of directors whom they believe would do a better job or implement acceptable policies. However, such recourse may be time-consuming, costly, and frequently unprofitable. Accordingly, many shareholders seek judicial redress as a remedy. The courts, leery of this drain on judicial resources where investors have voluntarily associated together for profit, and concerned about cumbersome decision-making devices, have developed rules to reduce the number of such cases that courts will hear.

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The principal doctrine embodying this reluctance is known as the business judgment rule. Most articulations of the business judgment rule start with its use as a “defense of director” action, since the initial application of the rule was to protect directors from liability. Yet, the roots of the rule lie in the grant of primary decision-making authority to directors. Modern courts and commentators view the business judgment rule as a logical derivative of the common statutory lodging of the board of directors’ authority to direct the control and management of the corporation. The statutes contemplate that all powers so granted will be exercised by the directors in their business judgment. Many judicial opinions simply restate the proposition that the particular matter or action was within the business judgment of the directors.

However, the rule is more commonly known for its use as a defense of director action. It is generally considered to be a shield behind which a director may make and act on decisions without the threat of personal liability. There are several versions of the rule, each articulated as some form of judicial nonintervention. In general, the business judgment rule defense creates a rebuttable presumption that directors acted in good faith and fulfilled their fiduciary duty of care, despite the fact that some business decisions went awry. The courts, presuming the exercise of business judgment unless shown otherwise, will not second-guess the decisions of corporate directors. The essence of the rule is captured in cases like Shlensky v. Wrigley. In Shlensky, an Illinois court applied the business judgment rule and declined to reverse the decision of directors of a professional baseball club not to install lights in its ballpark, even though the organization was the only club which had not done so and was therefore losing money.

The rule has engendered much litigation and considerable schol-
arly commentary. The continuing interest in the rule largely results from judicial attempts to balance the tension between the need for accountability on the part of directors and concern about unwieldy decision-making, adverse effects of the alacrity of qualified directors to serve on boards of directors, and the drain on judicial resources. The mere existence of this balancing highlights a rarely spoken and often overlooked truth: courts have always been willing to scrutinize director action to some extent, lest directors escape all accountability. Where a decision is tainted by a conflict of interest, director action is subject to exacting scrutiny. Courts will second-guess the merits of such tainted action taken by directors and evaluate its soundness under the intrinsic fairness standard. Illegal or fraudulent actions are also subject to judicial scrutiny. Although decisions such as Litwin v. Allen\(^9\) have been frequently criticized,\(^10\) courts have also second-guessed the merits of decisions of the directors of financial institutions.

The court in Litwin evaluated a substantive decision of the board and found it so flawed that it amounted to a breach of the directors' duty of care.\(^11\) Until Smith v. Van Gorkom,\(^12\) the corporate bar accepted the Litwin result as an aberration uniquely applicable to financial institutions.\(^13\) In Van Gorkom, the board of directors' decision to approve a cashout merger was held as an uninformed business decision, due to the absence of board knowledge of certain pertinent facts which would have made the decision a properly informed one.\(^14\) Although the result in Van Gorkom also appeared to evaluate the substantive decision of the directors, many commentators\(^15\) and lawyers\(^16\) have concluded that Van Gorkom emphasized a point inherent in the duty of care analysis, namely that courts will scrutinize the process by which decisions were made. Under this

8. Id. at 181, 237 N.E.2d at 780. The courts "should not interfere" with board decisions unless there are allegations of "fraud, illegality or conflict of interests." Id.
10. See R. Clark, Corporate Law § 3.4 (1986).
11. Litwin, 25 N.Y.S.2d at 737.
12. 488 A.2d 858 (Del. 1985).
view, \textit{Van Gorkom} does not mean that courts will subject the merits of director decisions to scrutiny. Yet, the \textit{Van Gorkom} court could not have awarded a remedy to the complaining shareholders unless it found that they had been harmed by the deficient process. It could have determined the existence of harm only by second-guessing the decision of the directors.

The connection between the process used by the directors in \textit{Van Gorkom} and the merits of the decision reached or action taken serves as the catalyst for this article. \textit{Van Gorkom} illustrates that the mere necessity of ascertaining the extent of injury means that courts will also second-guess the merits of decisions made by directors where the decision has been made through a deficient process. The traditional and familiar model of judicial nonintervention rests on the converse of this connection. As a general proposition, if the process used by the board is not deficient, then courts will not engage in evaluation of the substantive decision or action. No matter which side of this connection is viewed, the degree of judicial review of director action appears to be a function of the need for integrity in decision-making processes.

If this observation is correct, then several questions abound. What is adequate process? Those readers familiar with constitutional law precepts may recognize this question as: How much process is due? Is adequate process always the same or does it vary with the circumstances? What are the standards for merit evaluation of substantive decisions? This article further contends that the answers to these questions start with the importance of the integrity of decision-making processes to corporate management. The inherent disputes among shareholders in the normative model of corporate governance make it a catalyst for litigation. The use of high integrity decision-making processes may result in better decisions and actions, and thereby abate the catalytic powers of normative governance. Alternatively, they may produce greater respect for decisions and actions on the part of disappointed and dissenting shareholders and generate investor confidence in the corporate system.

Historically, director decision-making has been analyzed doctrinally according to specific fiduciary duties. Under these analyses, director decision-making falls generally into two discrete categories: decision-making that must be examined under the duty of care or the duty of loyalty. Decision-making, however, includes both the decisions and the processes by which the decision is made. This article argues that the decision and process components are not monolithic. Instead, each respectively encompasses a spectrum of various types of decisions or processes. At one end of the decision spectrum are decisions on matters likely to be reached under ordinary circumstances...
through the exercise of business judgment. At the other end are decisions on conflict of interest transactions between influential insiders\textsuperscript{17} and the corporation.\textsuperscript{18} This article refers to the class of decisions in the first instance as ordinary matters and in the latter instance as self-dealing.

The process spectrum parallels the decision spectrum. The process spectrum ranges from the inclusion of shareholders and disinterested directors, fairness constraints on substantive decisions, and actions in the case of self-dealing, to discretionary process without substantive decision constraints in the case of ordinary matters. The two spectra work together so that the specific measures necessary to assure integrity of process vary, based upon the nature of the decision or action taken by directors. The fiduciary duties of care and loyalty provide the principal doctrinal structure for these spectra.

Part II of this article describes the decision spectrum from decisions on ordinary matters to decisions of self-dealing. The area of the spectrum between the ends consists of decisions on matters possessing varying degrees of the characteristics of both polar categories. The intermediate area includes takeover defenses, reactions to derivative suits, and fundamental change transactions.\textsuperscript{19} Such decisions may be classified as mixed motive decisions, and may be recognized by the degree of potential dominance by the inherent conflicts of interests among collaborators in the corporate enterprise over business judgment.\textsuperscript{20} In this article, inherent conflicts of interest among collaborators other than those relating to self-dealing are referred to as intercollaborator conflicts.

Part III describes the spectrum of decision-making processes which correspond to their counterparts in the decision spectrum. Self-dealing, constituting the most dangerous form of conflict, requires greater

\textsuperscript{17} Dean Clark refers to transactions between "influential insiders" rather than merely directors or officers. Influential insiders are persons who have "decision making influence with respect to the actions taken by" the corporation. R. CLARK, supra note 10, at § 4.1 (emphasis omitted).

\textsuperscript{18} See Palmiter, Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence, 67 Tex. L. Rev. 1351, 1353 (1989) (recognizing three categories of decisions: (1) those measured by the duty of care; (2) those measured by the duty of loyalty; and (3) those involving mixed motives).


\textsuperscript{20} See Palmiter, supra note 18, 1333-54.
measures to assure integrity in decision-making. Decisions on ordinary matters require less formal measures to assure integrity. Decisions in the intermediate class require stronger measures than those needed for ordinary matters to assure integrity, but perhaps less stringent measures than those needed in the case of entity conflicts. However, the intermediate class of decisions is quite broad, and the level of danger from intercollaborator conflicts varies from decision to decision. The courts, confronted with intermediate class decisions, have required the use of processes with features specifically designed to reduce the influence of intercollaborator conflicts. These include the conducting of a reasonable investigation, the use of experts, reliance on independent and disinterested directors, disclosure to shareholders, and substantive constraints on decisions. In addition, some intermediate class decisions, such as fundamental change transactions, require the utilization of processes expressly mandated by statute.\textsuperscript{21} This article contends that these additional process requirements pressure boards of directors to assure shareholders and the courts that the board reached its decision in the exercise of business judgment.

By far, the most controversial measures adopted by the courts to assure decisional integrity have been the imposition of substantive constraints. Part IV analyzes the relationship between substantive constraints and decisional integrity, and argues that courts resort to substantive standards in an effort to cloak controversial corporate decisions with the integrity of the judicial decision-making process. This article concludes that courts will attempt to impose substantive constraints whenever they perceive that a decision was unduly influenced by intercollaborator conflicts, notwithstanding the use of acceptable process, or a deficient decision-making process used by directors. This article further concludes that, while it is not possible for the courts to craft perfect substantive constraints, they will not be deterred from attempting to do so merely because the task is difficult.

\section*{II. THE DECISION SPECTRUM}

Many articulations of the business judgment rule defense present a spectrum of board decisions. Attorney Samuel Arsht states that the defense is applicable only where "[a] corporate transaction . . . involves no self-dealing by, or other personal interest of, the directors who authorized the transaction."\textsuperscript{22} The defense is not available to protect all types of board decisions or actions; yet, the gamut does not run from the ordinary to the extraordinary. Instead, Arsht, as have

\textsuperscript{21} See infra note 57.

\textsuperscript{22} Arsht, supra note 2, at 111 (footnote omitted).
most courts and commentators, recognizes conflicts of interests, or
the absence thereof, as the distinguishing characteristic of director
decisions and actions that are protected by the business judgment
rule defense. His formulation, however, suggests three broad classes
of decisions or actions: those involving self-dealing, those otherwise
tainted by the personal interests of directors, and those to which the
business judgment rule defense is applicable.

Distinctions among board decisions also appear in cases such as
{
Sinclair Oil v. Levien}. In {
Sinclair}, minority shareholders chal-
lenged a dividend policy, a strategic business plan, and the perform-
cance of contractual obligations owed to the corporation by its parent.
The court indicated that the degree of its review would depend upon
the nature of the transactions or policies approved by the board.
It then analyzed each of the three board actions to determine the de-
gree of judicial scrutiny appropriate for each. The court stated that
dividend declarations qualified as a decision to which the business
judgment rule defense applied, unless the plaintiffs demonstrated
self-dealing, the absence of any reasonable business objective, or im-
proper motives. The strategic business plan, which prevented the
corporation from operating or developing opportunities outside of
Venezuela, also qualified as a decision under the business judgment
rule defense, unless the plaintiffs showed self-dealing or gross over-
reaching. However, the parent corporation's failure to make timely
payments and purchase minimum quantities of crude oil and refined
product constituted self-dealing.

The Arsht and Sinclair analyses of the business judgment rule de-

23. 280 A.2d 717 (Del. 1971).
24. The court stated that the intrinsic fairness standard does not apply solely by
virtue of the relationship between the parent corporation and the subsidiary. The
standard is applicable only in situations involving self-dealing. Id. at 720. See also
Supreme Court distinguished between dividend policy and a socialistic strategic busi-
ness plan.
26. The corporation argued that the business judgment rule defense applied unless
the plaintiff demonstrated gross and palpable overreaching. The court did not mention
this standard in its analysis of the dividend policy, other than to restate the corpora-
tion's argument. It did, however, articulate its application to the strategic business
plan. "Accordingly, Sinclair's decision, absent fraud or gross overreaching, to achieve
expansion through the medium of its subsidiaries, other than Sinven, must be upheld."
Id. The court may have resorted to this version of the business judgment rule defense
because it was not confronted with a specific transaction to which it could apply its
self-dealing test.
27. Id. at 723.
fense evince a spectrum of director decisions or actions, rather than
discrete classifications. Decisions or actions involving self-dealing are
at one end and those qualifying for the business judgment rule de-

defense are at the other. Accordingly, the middle includes a wide array
of transactions. These intermediate decisions and actions involve the
personal interests of directors under the Arsht description28 and im-
proper motives under the Sinclair analysis.29

A. Decisions Involving Self-Dealing

The decision spectrum is comprised of decisions or actions that
vary based on the degree and character of any conflicts of interest
within their composition, with matters of self-dealing representing
one pole of the spectrum. In Sinclair, the Delaware Supreme Court
distinguished self-dealing from other conflicts of interest transactions
by adding the provision that the parent company must receive some
benefit “to the exclusion of, and detriment to, the minority stock-
holders of the subsidiary.”30 Even though the court focused on the
exclusion of minority shareholders, the essence of self-dealing in-
volved corporate injury—the taking of something that rightfully be-
longs to the corporation.

The exclusionary benefit provision was necessary because the rela-
tionship between a parent corporation and its subsidiary, which has
minority shareholders, exacerbates intercollaborator conflicts. These
conflicts of interest naturally exist among those economic actors
seeking to further their own self-interest in their collaboration with
others. Collaboration does not mean that interests are always
aligned. The interests of controlling shareholders vary from those of
minority shareholders,31 while the interests of preferred shareholders
vary from the interests of common shareholders.32 The interests
of directors and officers vary from that of shareholders, especially
with executive compensation,33 defensive maneuvers against hostile
takeovers,34 and proxy fights.35

However, none of these participants would agree to collaborate un-
less they could further their self-interest. These intercollaborator
conflicts of interests are present in the self-dealing context where a
director is disloyal to the corporation. Moreover, these intercol-

28. See Arsht, supra note 2, at 111.
30. Id. at 720.
laborator conflicts of interests will exist no matter what the corporation does, and no matter what action or decision comes before the board of directors. If the courts subjected all board action that involved intercollaborator conflicts of interests to exacting scrutiny, the courts would replace boards of directors as the chief decision-making bodies for corporations. Thus, the *Sinclair* court used the exclusionary benefit provision as a benchmark for ascertaining whether the intercollaborator conflict of interest resulted in conduct that transformed its character into self-dealing.36

Unless that transformation occurs, director actions and decisions fall into the intermediate category or the business judgment defense category. The analysis of the dividend declarations in *Sinclair* illustrates this point. The Delaware Supreme Court indicated that the declaration would most likely be protected by the business judgment rule defense if it did not constitute self-dealing.37 However, it also indicated that the declaration might under some circumstances constitute an action tainted by improper motives.38 Dividend declarations of the latter type would not be categorized under the business judgment standard, nor would it be evaluated under the intrinsic fairness standard.39 Instead, such declarations would be valid unless they were not grounded on a reasonable business objective or they amounted to waste.40

36. The *Sinclair* definition is under-inclusive. It includes only those transactions in which an interested insider obtains a benefit not shared with other shareholders. However, many corporate statutes literally apply to any transaction between a director and the corporation. See, e.g., Del. Code Ann. tit. 8, § 144 (1984). Dean Clark largely follows the statutory approach and would treat any transaction between the corporation and influential insiders as self-dealing. Clark, supra note 10, at § 4.1. The legal consequence of self-dealing, thus, is an issue separable from that of whether conduct constitutes self-dealing. This article uses the term as it is defined in *Sinclair*.


38. *Id.* at 722.

39. This argument is based on two separate statements of the *Sinclair* court. The court first stated that compliance with statutory procedures and authority would "not, under all circumstances, justify all dividend payments. If . . . a dividend cannot be grounded on any reasonable business objective, then the courts can and will interfere with the board's decision to pay the dividend." *Id.* at 721. Implicit in its discussion of self-dealing is the conclusion that the courts would apply the intrinsic fairness standard only when the declaration amounted to self-dealing. That is, the directors or controlling shareholders received a benefit not shared with minority shareholders. However, the court's statement on judicial intervention does not limit it to only those dividends that constitute self-dealing. This point is confirmed by the statement that "[t]he motives for causing the declaration of dividends are immaterial unless the plaintiff can show that the dividend payments resulted from improper motives and amounted to waste." *Id.* at 722.

40. *Id.*
B. Decisions on Ordinary Matters

The other pole of the decision spectrum is generally limited to ordinary matters. Decisions on ordinary matters normally will be reached through the exercise of business judgment, even in the absence of strict process safeguards. Examples of ordinary matters include establishing the general direction and basic business policies of the corporation, as well as implementing and monitoring these directives and policies. Also included are the determination of when to declare a dividend and how much of a dividend should be paid; the hiring and firing of senior officers; the holding of corporate elections and the dissemination of relevant information to shareholders; and the determination of whether to bring legal action.

The presumption that director decisions are generally the product of business judgment creates a procedural obstacle which renders the class of decisions under the business judgment defense broader than the class of decisions under ordinary matters. All director decisions will be protected by the business judgment rule defense unless a complaining shareholder alleges circumstances which indicate that the directors reached a decision influenced by something other than their business judgment. Mere conclusory allegations of the improper influence of an intercollaborator conflict generally will not suffice. However, Sinclair implied that a transaction between a parent and its subsidiary constitutes a circumstance which suggests that directors were influenced by something other than their business judgment in taking action or making decisions. Under Sinclair, courts should first examine allegations of transactions between parent and subsidiary corporations for self-dealing. Sinclair also indicates that allegations that are not legally sufficient to show that a board's action or decision amounts to self-dealing, improper motives,

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41. See, e.g., MODEL BUSINESS CORP. ACT § 8.01(b) (Supp. 1989). The Act provides that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the Corporation managed under the direction of, its board of directors. . . ." Id. (emphasis added); see also Cheek, supra note 16, at 66-69.
45. McKee v. Rogers, 18 Del. Ch. 81, 156 A.2d 191 (1931); see also Starrels v. First Nat'l Bank, 870 F.2d 1168, 1173-74 (7th Cir. 1989) (Easterbrook, J., concurring).
46. See, e.g., Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984) (conclusory allegations that the owner of 47% of the stock of corporation dominated the directors were insufficient; plaintiff should have alleged specific facts that created a reasonable doubt that directors are disinterested and independent or that the transaction was not the product of business judgment); see also Grobow v. Perot, 539 A.2d 180 (Del. 1988).
48. If the allegations do not reflect self-dealing, then the transaction falls within the category of actions or decisions under the business judgment rule defense, unless the complainant advances sufficient allegations to indicate otherwise. Id.
or waste should be protected by the business judgment rule defense. Procedural rules thus establish the business judgment rule defense as a default rule which covers all board decisions unless a complaining shareholder pushes the right procedural buttons.

C. Decisions in the Intermediate Class

Decisions in the intermediate class may be described as those in which the influence of intercollaborator conflicts looms large. Comparing the contrasting treatment of dividend decisions in the historical case of *Dodge v. Ford Motor Co.* and *Sinclair* provides a picture of the intermediate class decisions. In *Ford Motor*, the Michigan Supreme Court reviewed a decision by Ford Motor Company to pay only modest dividends, notwithstanding recent substantial profits. Henry Ford was the controlling shareholder, and the Dodge brothers, who needed financing for a rival company, were minority shareholders. Under those circumstances, the court evaluated the propriety of the dividend policy by measuring it against this unspoken standard: Are profits in excess of the reasonable needs of the business?

The court in *Ford Motor* subjected a dividend policy to substantive constraints, while the *Sinclair* court utilized the business judgment rule defense. The distinction between the tests suggests that the character of decisions on dividend policy may vary. *Sinclair* apparently considered the dividend policy to be an ordinary matter, while the court in *Ford Motor* thought the dividend policy deviated from an ordinary board decision. The distinction between the circumstances surrounding the dividend policy in *Ford Motor* and those in *Sinclair* suggest that the chief characteristic of intermediate class decisions lies in the degree to which an intercollaborator conflict of interest influences a particular action or decision.

Much of the confusion surrounding the scope and proper application of the business judgment rule defense arises out of intermediate class decisions, although intercollaborator conflicts can also be present in decisions involving ordinary matters. Intermediate class decisions differ from decisions on ordinary matters in that the intercollaborator conflicts are central to the particular action taken or decision made. An ordinary matter may affect shareholders differ-

49. Id. at 722.
51. Id. at 509-10, 170 N.W. at 685.
ently, as, for example, the payment of exorbitant dividends as a source of financing for the parent corporation in *Sinclair*. An intermediate class decision may not only affect shareholders differently, it may be designed to treat them differently, as shown in *Dalton v. American Investment Co.*54 where common shareholders were cashed out in a merger while preferred shareholders were locked in. Additionally, the decision may be designed to benefit one shareholder at the expense of other shareholders, as shown through the payment of excessively modest dividends in *Ford Motor* which dried up the source of financing for a competing business; or, it may provide directors and officers with an advantage perpetuating their offices at the expense of shareholders as did the advancement of the annual meeting date in *Schnell v. Chris-Craft Industries*.55

Intermediate class decisions necessarily include the approval of the fundamental change transactions,56 and may also include other transactions not involving certain tainted motives.57 These transactions, however, can involve a change in the collaborative agreement, and this change may be accomplished despite a shareholder’s objection. Those shareholders and directors who approve of a change in the collaborative agreement further their self-interest, just as those who object to a change further their own self-interest. Those who approve the change in the collaborative agreement do so because it benefits them at the expense of those who object. Intercollaborator conflicts thus rest at the core of decisions approving such transactions.

One final comment about the nature of intermediate actions: Challenges to them often may be brought as direct actions rather than derivative. And, it is possible that the transaction may be in the best interests of the corporation. For example, the merger in *Van Gorkom* may well have been in the best interests of the corporation given the tax problem that motivated the merger.58

54. 490 A.2d 574 (Del. Ch.), aff’d, 501 A.2d 1238 (Del. 1985).
56. Fundamental change transactions include amendments to the articles of incorporation, mergers, consolidations, share exchanges, sales of substantially all of the corporation’s assets, dissolution, and revocation of dissolution. These transactions are adjacent to self-dealing transactions on the decision spectrum, and are classified as intermediate class transactions in this article because they do not necessarily include self-dealing; although state corporation codes provide some of the same process safeguards prescribed for self-dealing transactions. For example, corporation codes normally require the submission of these transactions to shareholders for a vote, approval by a majority of all shareholders rather than by the majority of a quorum, and the right of dissenting shareholders to receive the fair value of their shares. See generally *MODEL BUSINESS CORP. ACT* §§ 11.01-14.40 (1984 & Supp. 1989).
58. *Van Gorkom*, 488 A.2d at 864-65. The corporation enjoyed too many tax
III. THE PROCESS SPECTRUM

A spectrum of decision-making processes corresponds with the decision spectrum. Corporation codes prescribe a baseline process, consisting of meetings and voting, for all board decision-making. As a practical matter, corporate decision-making culminates in the baseline formalities; actual decision-making frequently encompasses processes other than meetings and votings. The decision spectrum discussed here focuses on those decision-making processes beyond the baseline process. The case and statutory law reveal a bipolar spectrum that includes a large intermediate class of processes. The poles are represented by the individualized process required under the duty of care and the collective process required when the duty of loyalty is at stake. The intermediate class of processes contains elements of both.

A. Process Under the Duty of Care

The corporate law of most states, whether by statute or common law, imposes a fiduciary duty of care on directors in the exercise of their business judgment. The duty of care as normally formulated by statute or case law requires good faith, the use of the skill, care and diligence of an ordinarily prudent person under similar circumstances, and attempts to further what a director believes to be the best interests of the corporation. The duty of care is imposed on each individual director. The business judgment rule defense presumes that directors have satisfied their duty of care, both in selecting processes and in the making of substantive decisions.

The presumption that directors have satisfied the duty of care does not mean they may freely breach their duty of care without consequence. The business judgment rule defense does not protect directors who breach their duty of care. At a minimum, the duty of care requires directors to use adequate process in performing their duties. Each director individually should reach a decision on board matters through processes that a director acting in good faith as an ordinarily prudent person trying to further the best interests of the corporation

breaks. The nature of its business yielded investment tax credits which were meaningless because its depreciation cost recovery effectively reduced any tax liability against which the credits could be used.

60. MODEL BUSINESS CORP. ACT § 8.30(a) (Supp. 1989).
61. Arsht, supra note 2, at 118-20.
would use. A director may be subject to personal liability for the failure to use appropriate process to fulfill the duty of care. Where the validity of the decision is concerned, however, the group process or the sum of the individual processes are important. Ordinarily, the corporation cannot suffer harm from a breach of the duty of care unless a majority of the directors breached that duty.

Perhaps the most important element of the duty is the obligation to become informed about the business and financial affairs of the corporation, and about the circumstances of a particular action or decision. The business judgment rule defense will not be available unless a director was adequately informed of the relevant circumstances. However, directors possess wide discretion in determining the manner in which they become informed.

Such discretion is implicit in the grant of authority to take action and make decisions within their business judgment. The statutory grants of power usually do not prescribe specific decision-making processes. Most statutes expressly recognize that directors, especially outside directors, will have to rely on officers, other employees, and professionals for information on which to base their decisions. Statutes today are designed to relax any judicial requirements that directors must become experts themselves on every aspect of the corporation's business. Reliance on delegatees in decision-making processes will not be required, but will be permitted.

B. Process Under the Duty of Loyalty

The discretion of directors to select the processes by which they consider transactions between the corporation and interested directors is limited by case and statutory law. Historically, such transactions were per se void as violations of the duty of loyalty. Under current law, such transactions are voidable unless they are intrinsically fair to the corporation. The Delaware Supreme Court has noted that fairness has two components: fair course of dealing and fair price. The latter component is a substantive constraint on the

62. Many jurisdictions have enacted statutes which permit shareholders to adopt or amend articles of incorporation to eliminate the personal liability of directors to shareholders or the corporation for the breach of the duty of care. Steinberg, The Evisceration of the Duty of Care, 42 Sw. L.J. 919, 920, n.12 (1988).
63. Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981) (a director should become familiar with the fundamentals of the transactions in which the corporation is involved).
64. Arsht, supra note 2, at 111-12, 119-20.
65. See, e.g., DEL. CODE ANN. tit. 8, § 141(e) (Supp. 1988); MODEL BUSINESS CORP. ACT § 8.30(b) (Supp. 1989).
66. R. Clark, supra note 10, at § 5.1.
terms of the transaction that may be approved by the directors,\(^6\) while the former examines the process by which the transaction was
approved. A fair course of dealing requires good faith and full disclosure of both the conflict of interest and material terms of the transaction to shareholders or disinterested directors who must vote to approve the transaction.\(^6\) It will include a wide range of acceptable processes.\(^7\) Statutes applicable to such transactions require fairness, as well as disclosure to, and approval by, disinterested directors or shareholders.\(^7\) Good faith within fair dealing requires the directors to act with proper motives and in the best interests of the corporation.

The applicable statutes often prescribe the range of process in the disjunctive. For example, the utilization of one, but not all, of the given processes is properly within the literal language of the statutory requirements.\(^7\) It might appear that compliance with the disinterested director or shareholder vote would obviate the need for the transaction to pass the fairness test. But such is not the case.\(^7\) However, under Delaware law, "an informed vote of the majority of the minority shareholders" will shift the burden of proof on the issue of fairness to complaining shareholders.\(^7\) If the transaction is approved through a sound and honest process that will give shareholders and courts confidence that an error was not likely to result, the transaction is presumed to be fair.

Unlike the processes permitted at the other pole, the concern here

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6. Fair price embraces "the economic and financial considerations . . . including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." \(\text{Id.}\)

6\(^{\text{a}}\). \(\text{Id.}\)

7. In \textit{Weinberger}, the court stated that fair dealing encompasses "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained." \(\text{Id.}\)

7\(^{\text{a}}\). \text{See, e.g., DEL. CODE ANN. tit. 8, § 144 (1984).}

7\(^{\text{b}}\). Delaware law provides that no conflict of interest transaction shall be void or voidable solely because of the conflict "if: (1) . . . or (2) . . . or (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors." \(\text{Id. at § 144(a).}\)

7\(^{\text{c}}\). In \textit{Fliegler v. Lawrence}, 361 A.2d 218, 221-22 (Del. 1976), the Delaware Supreme Court held that section 145 of the Delaware Corporations Code does not sanction unfairness. Accord, \textit{Marciano v. Nakaah}, 535 A.2d 400 (Del. 1987). However, in \textit{Rosenblatt v. Getty Oil Co.}, 493 A.2d 929 (Del. 1985), the Delaware Supreme Court held that the use of the procedure set forth in Delaware Corporations Code section 144(a) (2)—disclosure to, and approval by, shareholders—shifts the burden of proving unfairness to the complaining shareholder. \textit{Rosenblatt}, 493 A.2d at 937.

7\(^{\text{d}}\). \textit{Rosenblatt}, 493 A.2d at 937.
shifts from the individual process to the collective process. The integrity of decision-making that involves the duty of loyalty rests on the substance of the transaction, and the process by which the board approved it, rather than on the process used by individual directors in deciding how to vote.

C. Intermediate Process and the Duty of Fair Dealing

Directors owe shareholders a duty of fair dealing. They may not favor certain shareholders over others except as permitted in the articles of incorporation. Controlling shareholders also owe minority shareholders a fiduciary duty of fair dealing. Directors are supposed to perform their work for the benefit of shareholders and not for themselves. These rules directly address the potential for injury to minority shareholders due to intercollaborator conflicts of interest. When deciding cases in which these conflicts appear, the courts, while expressing concern, have not provided consistent analyses of applicable rules. Courts will often categorize these cases as duty of care, business judgment rule, or duty of loyalty problems. Courts have been more consistent when addressing the fiduciary duty of controlling shareholders, but frequently it is not clear whether the duty of fair dealing is an independent duty or whether it is part of the duty of loyalty.

Even if the applicable rules are not clear, the general underlying themes reflected in these cases have been remarkably consistent. A major theme holds that the business judgment rule should not shield actions or decisions that may result from the taint of an intercollaborator conflict rather than the exercise of independent business judgment. In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court examined an “inherent conflict” that was the “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.” Where such conflicts are present, the courts express a need to police such actions and decisions with greater scrutiny. The *Unocal* court noted that “there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.”

The inherent conflict between directors and shareholders is also

76. *Dalton*, 490 A.2d at 583-85; see also *Speed v. Transamerica Corp.*, 235 F.2d 369, 373-74 (3d Cir. 1956).
77. 493 A.2d 946 (Del. 1985).
78. *Id.* at 954.
79. *Id.*
raised in cases such as Burks v. Lasker\textsuperscript{80} and Zapata Corp. v. Maldonado,\textsuperscript{81} wherein committees of disinterested directors recommended the dismissal of derivative suits. In Zapata, the court framed the issue in terms of "whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors."\textsuperscript{82} Again, the Delaware Supreme Court imposed a larger policing role for the courts. If a lower court determines that the committee used proper process, the Zapata court noted that it should then evaluate the committee's recommendation to dismiss the derivative action by substituting its own business judgment for that of the committee.\textsuperscript{83}

In executing this larger policing role, the courts have extended the individualized process requirements of the duty of care and borrowed elements of the collective process required under the duty of loyalty to produce a hybrid, intermediate class of process. Intermediate process, as thus developed, includes the use of one or more of the following: a reasonable investigation, independent or disinterested directors, expert advice, disclosure to shareholders, and substantive constraints on the action or decision. It should be noted that these requirements are not necessarily new ideas of the judiciary.

The obligation of individual directors to become informed remains\textsuperscript{84} but, implicitly, the duty to conduct a reasonable investigation is imposed on the collective board of directors in addition to individual directors. In Cheff v. Mathes,\textsuperscript{85} two directors undertook personal investigations of the reputation of a potential buyer of the corporation and reported their results to the other directors. The Cheff court imputed the investigations to the full board.\textsuperscript{86} Where a reasonable investigation is necessary, if individual directors are to fulfill

\textsuperscript{80} 441 U.S. 471 (1979).
\textsuperscript{81} 430 A.2d 779 (Del. 1981).
\textsuperscript{82} Id. at 786.
\textsuperscript{83} Id. at 789. For a proposed statutory response to Zapata and its progeny, see \textit{American Law Institute, Principles of Corporate Governance: Analysis and Recommendations} § 7.08–11 (Tentative Draft No. 9, Apr. 14, 1989) (as modified at the 1989 ALI Annual Meeting) (specifically contemplates judicial review as a part of corporate decision-making) and § 7.44 (proposed), \textit{printed in Committee on Corporate Laws, Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings}, 44 \textit{Bus. Law.} 543 (1989) (enhances process requirements but retains role for traditional business judgment rule defense).
\textsuperscript{84} Smith v. Van Gorkom, 488 A.2d 858, 873-75 (Del. 1985).
\textsuperscript{85} 199 A.2d 548 (Del. 1964).
\textsuperscript{86} Id. at 556.
their obligations to become informed, the investigation should be conducted by or under the auspices of the full board.

The group obligation to conduct a reasonable investigation is further supported by other elements of intermediate process, such as the use of independent directors and experts. For example, it is now common practice to delegate the conduct of an investigation and the decision of whether to seek the dismissal of a derivative suit to a committee of disinterested directors. The conducting of an investigation by an independent committee is crucial to a motion to dismiss a derivative suit. Some courts have also recognized the reliance of a committee on experts. Courts frequently look for the use of financial experts when boards consider the sale of the corporation and when boards determine defensive actions necessary to repel hostile takeovers.

Requiring the use of disinterested directors is based on the premise that they, by virtue of their disinterest, are more likely to conduct reasonable investigations than those tainted with an interest. Further, disinterested directors are more likely to rely on the results of that investigation. Experts are required because of their ability to view matters objectively and accurately, and to render professional opinions about legality and value. For example, directors who are buying assets from a corporation may be capable of valuing the assets correctly, but will also be susceptible to the human inclination of a buyer to value the assets as low as possible. A financial analyst will seek to ascertain an accurate value, whether higher or lower than the value seen by the directors.

In some instances, the entire board may act rather than delegate the decision to a committee of disinterested directors. Here, inquiries will be directed toward the entire board and the process it used to assure that it reached an independent business judgment. However, where the taint of the intercollaborator conflict of interest is unavoidable, an independent business judgment necessitates a greater role for outside directors. An action of the board is more likely to be viewed as the product of an independent business judgment where disinterested directors have played pivotal roles.

Substantive constraints that limit the permissible terms of a transaction constitute the most controversial component of intermediate

87. R. Clark, supra note 10, at § 15.2.
90. Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); see also Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
91. Aronson, 473 A.2d at 814-16.
92. Unocal, 493 A.2d at 955.
process, for such constraints demonstrate judicial second-guessing. When the business judgment rule defense is applicable, its very essence precludes an evaluation of the merits of a board decision or action. *Smith v. Van Gorkom* was surprising because the court transcended traditional boundaries when it determined that a substantial gain produced by a decision was not enough. Attorney Arsht had acknowledged prior to *Van Gorkom* that the business judgment rule defense does not preclude judicial merit evaluation where directors have not fulfilled their individualized process obligations under the duty of care.93

The duty of fair dealing applies generally to conflicts among controlling and minority shareholders. As the nomenclature suggests, decisions involving this conflict are subject to the constraint of fairness. In the freeze-out merger context, some jurisdictions also add the requirement that the merger have a business purpose other than the elimination of minority shareholders.94 Fairness constraints, however, do not generate the heart of the controversy. More important problems arise where the courts attempt to impose substantive constraints other than fairness. Although the court articulated a substantive constraint on dividend policy in *Dodge v. Ford Motor Co.*,95 the standard advanced by the court shed little light on how to compute the amount of a dividend in future cases.

The difficulty with substantive constraints lies in the inherent premise that there are some decisions or actions which should or should not be made. How are directors, who must take action or make decisions without a perfect view of the future, to know what those actions or decisions are? If courts know which decisions should and should not be made, how do they inform directors without substituting board decisions with judicial intervention? The result has been a hotchpot of somewhat vague common law standards developed as courts have reviewed cases that appeared ripe for substantive constraints.

*Van Gorkom* holds, to the extent it articulates a constraint, that directors must actively seek to maximize shareholder return when

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93. *Arsht, supra* note 2, at 111.
95. *See supra* notes 50-52 and accompanying text.
they approve a sale of the corporation. This constraint is not inconsistent with the general profit-making motive and risk-taking. The judicial treatment of motions to dismiss derivative suits authorized by committees of disinterested directors perhaps better epitomizes the hotchpot. Zapata, for example, has been criticized for its imposition of substantive constraints on the decision of a committee of directors to seek dismissal of a derivative suit. The major flaw is not so much the interference with the business judgment rule defense, but the failure to articulate the principle upon which director decisions will be evaluated. The Second Circuit Court of Appeals, mindful of the criticism of Zapata, advanced this standard in Joy v. North: A court should dismiss a derivative action if the costs of continuing it outweigh the probable gain from doing so.

Intercollaborator conflicts among directors and shareholders provide fertile ground for substantive constraints, but the duty of fair dealing and fairness constraints are less meaningful. For example, the compensation of incumbent executives may be extravagant by societal norms and seem unfair to many, but if the compensation is comparable to what a corporation would have to pay in the market for corporate executives, general perceptions of fairness are not particularly useful. In fact, the substantive constraint on such compensation boils down to whether the compensation bears a reasonable relationship to the services rendered.

Takeover defenses have produced several attempts to formulate substantive constraints. Unocal Corp. v. Mesa Petroleum Co. limited the defensive actions that a board of directors can utilize to those "reasonably related to the threat posed." Other cases require directors to take actions that advance the cause of shareholder wealth. The court in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. required directors to conduct an auction whenever "it became apparent to all that the break-up of the company was inevitable." That constraint has been expanded and, as fre-

96. Dean Clark evaluated the criticisms of Zapata and argued that this failure is not a major flaw because courts engage in the same evaluation of the substantive merits of director decisions when they examine self-dealing decisions. R. Clark, supra note 10, at § 15.2.
98. 692 F.2d 880 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).
99. Id. at 892.
102. See, e.g., Dynamics Corp. v. CTS Corp., 805 F.2d 705 (7th Cir. 1986).
103. 506 A.2d 173 (Del. 1986).
104. Id. at 182.
quently occurs with such constraints, has also been watered down.\textsuperscript{106} Additionally, directors may approve lock-up options where they seek to stimulate bidding, but not where it precludes bidding.\textsuperscript{107}

Contests for voting control of a corporation also produce attempts to impose substantive constraints. The Delaware courts have shown a heightened sensitivity to cases where an incumbent board of directors either changes the rules of the shareholder electoral process or takes some other action to avert a victory by one or more shareholders. In \textit{Schnell v. Chris-Craft Indus.},\textsuperscript{108} a board of directors, facing a contested election, advanced the election date to shorten the campaign period for the nonincumbent candidates. Although this action was expressly permitted by statute, the court rejected it, holding that directors may not take action which is inequitable.\textsuperscript{109}

IV. SUBSTANTIVE CONSTRAINTS AND INTEGRITY OF PROCESS

\textit{Unocal Corp. v. Mesa Petroleum Co.} implied a direct relationship between the strength of intercollaborator conflicts and the likelihood that a decision is not the product of business judgment. The enhanced duty referred to by the \textit{Unocal} court means that a board must take steps to assure all concerned parties that the decision was indeed the product of business judgment. The approach of the court indicates that such assurance is obtainable through integrity of process. The proposition is a simple one: the greater the degree of integrity in the decision-making process, the greater the probability that the decision resulted from the exercise of business judgment. Additionally, a board must do more to show integrity in intermediate class decisions than in the case of decisions on ordinary matters. \textit{Smith v. Van Gorkom} echoes the \textit{Unocal} analysis. The \textit{Van Gorkom} board failed to take adequate steps to assure that the decision was produced through business judgment.

However, integrity of process does not seem to explain the application of substantive constraints by the courts to intermediate class de-

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{105} See infra note 122 and accompanying text.
\item \textsuperscript{107} \textit{Revol}, 506 A.2d at 182-84.
\item \textsuperscript{108} 285 A.2d 430 (Del. Ch. 1971).
\item \textsuperscript{109} \textit{Id.} at 439. The inequitable purpose of the directors was the perpetuation of themselves in office. \textit{Id.} Professor Branson has called the \textit{Schnell} inequitable action doctrine a "wild card" rule, and traces its application in election, freeze-out merger and takeover cases. Branson, \textit{The Chancellor's Foot in Delaware: Schnell and its Progeny}, 14 J. CORP. L. 515 (1989).
\end{enumerate}
\end{footnotesize}
cisions. If a board utilizes measures to assure integrity of process and the exercise of business judgment, why are substantive constraints necessary? Two reasons may be forwarded. First, substantive constraints establish the standards against which decisions produced through deficient process are evaluated. This rationale explains the Van Gorkom conclusion that the board caused injury to the complaining shareholders because the actual value of the corporation was greater than the amount obtained by the board of directors.\(^{110}\)

Second, notwithstanding the integrity of the process used by a board of directors,\(^{111}\) there are some decisions which, in the exercise of business judgment, should or should not be made under the circumstances. Litwin v. Allen, although generally recognized as an aberration to the business judgment rule defense,\(^{112}\) demonstrates this justification. Perhaps the court reached the result in Litwin because it was really an intermediate class decision. That is, the decision may have been tainted by the influence of intercollaborator conflicts. Dean Clark indicates that the opinion implies that the court noted the influence even though the plaintiff could not prove it.\(^{113}\) The court may have found negligence on the part of the directors because it believed the decision was one that directors exercising business

\(^{110}\). Smith v. Van Gorkom, 488 A.2d 858, 874-78 (Del. 1985). The court appeared to give short shrift to the element of causation. It remanded the case to the Court of Chancery to conduct a fair value proceeding in accordance with Weinberger v. UOP and assess damages. Van Gorkom, 488 A.2d at 893. Presumably, if the fair value were higher than the price obtained by the directors, the complaining shareholders would have been deemed harmed by the deficient process.

\(^{111}\). The court in Zapata Corp. v. Maldonado expressed reservations that a board could ever attain true independence where directors are the subject of a derivative suit:

> [W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a “there but for the grace of God go I” empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

Zapata, 430 A.2d at 787. Similar reservations are reflected in the two-prong test adopted in Aronson, which examines director independence and business judgment separately. See supra note 46.

\(^{112}\). The case in many ways resembles an intermediate class case. Some banking transactions, by their very nature, raise concerns similar to those about intercollaborator conflicts. Professors Cary and Eisenberg argue that certain financial transactions possess three unique characteristics that may warrant more stringent standards: (1) a corporation that regularly receives cash from a class of persons who have a special relationship with the corporation other than that of debtor-creditor; (2) the temptations that accompany the handling of large amounts of liquid cash; and (3) obligations imposed by specific statutes. Cary & Eisenberg, supra note 13, at 516-17. Thus, the directors of financial institutions may have a duty, solely because of the nature of the business it conducts, to undertake measures to assure that a decision results from the exercise of business judgment.

\(^{113}\). R. Clark, supra note 10, at § 3.4

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judgment would not have made.114 The business judgment rule defense was not applicable, although many scholars have argued that it should have been, because the directors had not, in light of the lurking intercollaborator conflict, assured the court that the decision resulted from business judgment.

Takeover cases provide other examples of the second justification for substantive constraints. *Unocal*, in essence, holds that directors acting within their business judgment would not choose a takeover defense which is not reasonably related to the threat posed. *Dynamics Corp. v. CTS Corp.*,115 a case involving an Indiana corporation, adhered to the *Unocal* standard and articulated a similar concept. Directors acting within their business judgment would not select a takeover defense which was adverse to the maximization of shareholder wealth. The court in *Unocal* upheld a decision to use a self-tender offer while the *Dynamics* court upheld a decision to adopt a poison pill. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the court applied the *Unocal* standard to invalidate decisions to approve a lock-up option and no-shop provision to terminate bidding during the course of an option.116

Assuming that the second justification is correct, the judicial promulgation of substantive constraints presumes that courts are suited to determine which decisions should and should not be made, and that business decisions involving varying degrees of risk are suitable for evaluation against such constraints. Experience with the judicial adoption of substantive constraints raises a question about whether courts are the appropriate institutions for deriving substantive constraints for risk-taking decisions, rather than other institutions like boards of directors. Sooner or later, a final decision must rest with some imperfect human agency, and courts are not yet perfect institutions.

For example, the court may have done the right thing in *Litwin*, but its use of negligence as a substantive constraint did not illuminate the parameters of the constraint. Unfortunately, the methodology of the *Litwin* court occurs all too often in intermediate class decision

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114. *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982), characterized *Litwin* as a no-win decision. The court described the transaction as one from which the corporation had no upside but incurred all of the downside risk. According to the *Joy* characterization, directors should not approve such transactions.

115. *Dynamics Corp. v. CTS Corp.*, 805 F.2d 705, 708 (7th Cir. 1986).

cases. Courts institute the required scrutiny and evaluation of the merits, and then pronounce lofty but vague constraints which provide little guidance to directors and the corporate bar about future transactions. The substantive constraints must be refined, ignored, or retracted on a case-by-case basis. The Delaware experience with the duty to conduct an auction in takeover cases provides an example of this approach.

In *Revlon*, the Delaware Supreme Court imposed a duty to auction once it became clear that a break-up of the corporation was inevitable. The Delaware courts have attempted to refine the contours of this substantive constraint in several subsequent auction cases. The Delaware courts have also addressed such questions as: what constitutes a break-up or a sale of the corporation, and, what is an auction?

However, in *In re Time Inc. Shareholders Litigation*, the Delaware Chancery court pointed out the limits of the duty to auction as a substantive constraint. The duty to auction was not considered the kind of constraint on the particular terms and conditions where a court might evaluate the approval of transaction and say that directors exercising business judgment should not have sold the corporation on those particular terms and conditions. Instead, the constraint is one that requires the directors to proceed in a specific way to maximize the return to shareholders, but only in those circumstances in which directors exercising their business judgment would decide that the auction is the most reliable means of obtaining maximum value. The court designated those circumstances as the “Revlon mode.” And, according to the court, the Revlon mode was

117. See Macey and Miller, *supra* note 19, at 131-32.
121. See *Mills*, 559 A.2d 1261; *In re J.P. Stevens & Co.*, 542 A.2d 770; *In re RJR Nabisco*, 94,194.
123. *Time*, at 93,276.
124. *Id.*
125. *Id.* at 93,277.
not triggered by the transaction at issue in In re Time.\(^{126}\)

Even though the Revlon mode may not have been triggered, the case did involve an intermediate class decision to which the court applied the Unocal standard.\(^{127}\) The court treated the recasting of the transaction as a defensive measure to which Unocal was applicable, but found that the measure was reasonable in relation to the threat imposed.\(^{128}\) The court ultimately held that the approval of the merger and rebuff of the Paramount bid was protected by the business judgment rule defense.\(^{129}\) The Time board had taken sufficient steps to assure integrity of process so that its decision could reasonably be said to result from business judgment.

Parallel experiences occur in Delaware with the development of the business purpose rule\(^ {130}\) and the Schnell inequitable action rule.\(^ {131}\) In each instance, the courts articulated imperfect substantive constraints which were not capable of providing guidance for future compliance in all cases. The issuance of the constraints invited additional litigation, as well as announced the willingness of the judiciary to use its limited resources to police director decisions. Moreover, the substantive constraints were placed on top of enhanced process requirements. If such constraints provide less certainty to directors and increase the drain on judicial resources, why do courts resort to them?

Unocal provides a hint in its enhanced duty language. "[T]here is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be con-

\(^{126}\) Id.
\(^{127}\) The case started as a merger between Time Inc. (Time) and Warner Communications, Inc. (Warner). After Paramount Communications, Inc. (Paramount) launched a cash tender offer for shares of Time, the merger was recast as a cash tender offer by Time for shares of Warner. The directors of Time unashamedly confessed their motivation, in negotiating the consolidation of the Time and Warner enterprises, to assure that they remained in control of the merged enterprise, albeit that the motivation was supported by business objectives. A recurring theme of the directors was the necessity of preserving the editorial independence of Time publications. Time, 94,515, at 93,268-69.
\(^{128}\) Id. at 93,281-84.
\(^{129}\) Id. at 93,284.
\(^{131}\) See supra notes 109-10 and accompanying text. For an interesting history of the Schnell doctrine, see Branson, supra note 110.
ferred." Clearly, the court believed that judicial inclusion is a part of the process. The court pronounced the reasonable relationship standard as one to be applied at the threshold. Thus, the standard is one that tests for business judgment, but it is the court that will apply the test. One may conclude that this particular substantive constraint was not formulated because it removes the judicial system from the corporate decision-making process, but because it actually injects the courts into the process.

*Zapata Corp. v. Maldonado* articulated similar concerns. The court addressed the issue of the drain of judicial resources and found the concern not compelling. It also considered "the danger of judicial overreaching" but found "the alternatives . . . outweighed by the fresh view of a judicial outsider." What advantages does the judiciary provide that favor its inclusion in corporate decision-making? Could it be that injecting the courts into corporate decision-making adds the ultimate element to integrity of process? It brings to corporate decision-making an institution subject to a high degree of accountability, imbued with impeccable integrity.

Perhaps the courts are concerned that intercollaborator conflicts left unchecked would shake investor confidence in the markets. After all, the existence of intercollaborator conflicts is well-known, and *Schnell* and a host of other cases demonstrate the capacity of directors and officers to rigidly follow any procedural process requirements. The investing public may remain skeptical about the approval of a transaction even though the decision-making process is sound. If a court upholds the decision on the basis that the process was sound, the public may conclude that wrongdoing was protected by a technicality. But if the court examines the substance of the decision and approves it, the decision may be more readily accepted. Whether it is wise for courts to place their institutional power on the line in these cases is left for another article.

Even if courts are suited to divine substantive constraints, possess special competencies to evaluate substantive decisions, as suggested by *Zapata*, and analyze the flaws of corporate decision-making,

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133. *Id.* at 955.
135. *Id.*
136. The Delaware court expressly acknowledged this concern in *Zapata*. "The second step [application of the court's own business judgment] is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit . . . ." *Id.* at 789.
137. The court in *Zapata* stated:

> In pursuit of the course, we recognize that "[t]he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors—ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal" . . . . But we are content that such factors are not
courts will still not be able to articulate constraints that neatly apply to all risk-taking decisions. The essence of the business judgment rule defense recognizes the existence of many possible correct courses of action in any given situation. It is not possible to devise or construct a rule that will tell directors which course of action is permissible in every case. Of course, substantive constraints necessarily will be applied where the directors have used a deficient process.

But when will courts attempt to apply substantive constraints and engage in an evaluation of the merits of director decisions other than in self-dealing cases? Courts are most likely to resort to substantive constraints in cases involving intermediate class decisions, in which the intercollaborator conflict rises to the level of an "omnipresent specter." As Unocal and other cases indicate, courts are most likely to impose constraints whenever they perceive that a decision has the capacity or undue influence by intercollaborator conflicts, notwithstanding the use of acceptable process.

Consistent with the history of judicial reluctance to order affirmative acts, courts are more likely to try substantive constraints in the case of decisions that should not be made in the exercise of business judgment than those decisions that should. Revlon, Schnell, and Unocal all involved standards for determining whether a decision should not have been made. Van Gorkom stands as an aberration, and perhaps means only that courts will look at decisions that ought to be made only where the question of damages arises due to the use of defective process or other failure to exercise business judgment.

V. CONCLUSION

This article has relied heavily on Delaware case law because of the myriad of available case history. However, the author's intent is not to suggest that the Delaware experience has occurred in all jurisdictions. Instead, this article suggests that courts in other jurisdictions also grapple with these issues, face similar concerns, and frequently follow the Delaware courts. Accordingly, this article rests on the premise that the Delaware courts do provide some basis for extrapolating the general attitudes and perspectives of courts regarding these matters.

"beyond the judicial reach" of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems.

Id. at 788 (quoting Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980)).

Whether courts seek integrity of process or the exercise of business judgment where intermediate class decisions are concerned, it cannot remove the risk from profit-making decisions. Courts should take great care in articulating substantive constraints added to enhanced process duties, for injecting themselves into corporate decision-making processes places societal respect for the judiciary at stake. Disappointed and dissenting shareholders may not become any less so merely because a court has determined that the board of directors made a legally valid decision. Judicial origination of substantive constraints will succeed only if corporate decision-making objectively improves so that there are fewer disappointed and dissenting shareholders.

However, these cases have a decided equitable influence. Directors and the corporate bar should not expect less judicial overreaching, for equity never sleeps. In fact, courts may be even more diligent in their scrutiny since many jurisdictions now statutorily permit the abrogation of the personal liability of directors for the breach of their duty of care.139 These statutes do not shield directors in self-dealing cases and may provide only limited protection in intermediate decision cases.