The Business Judgment Rule Revisited

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Those legal precepts that speak to when a court will intervene at the behest of stockholders in the decisions of the board of directors and impose liability on directors, officers, and controlling stockholders for their business decisions are central to any proposed revision of existing corporate governance policies. One such precept is the business judgment rule, a common law principle of corporate governance that has been part of corporate law for at least 150 years.¹ Notwithstanding its longevity, the business judgment rule is today misunderstood, at least if one is to judge from the comments of its critics, who are, in the main, distrustful of state corporate laws and are led to suggest that the business judgment rule promises more in the way of immunity from liability² than in reality it does. The misunderstanding stems, I suspect, both from the general failure to distinguish the business judgment rule from the


presumptions and limitations that surround the rule’s application and from the tendency of courts to use loose language in expressing the rule. Subsuming the presumptions and limitations under the term “business judgment rule” leads to confusion because the single term is then employed with reference to wholly different aspects of the rule’s application, which are governed by disparate legal principles. Judicial penchant for colorful phrases such as “gross negligence,” “gross abuse of discretion,” and “palpable overreaching” simply fuels the fire.

The current interest in, and emphasis on, directors as responsible overseers of the corporation and the movement toward requiring outside independent directors to assume the important oversight responsibilities performed by, for example, audit, compensation, and nominating committees make it imperative that

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3. Inasmuch as Delaware decisions have borne the brunt of the criticism, this Article focuses primarily on Delaware decisions in responding to such criticisms and in attempting to dispel the confusion surrounding the scope and operation of the business judgment rule.


5. The speed with which those who advocate federalizing corporate law pounce on the Delaware Supreme Court’s use of the phrase “gross and palpable overreaching” in Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970), without an appreciation of the special circumstances in which the term was used, see text accompanying notes 45-51 infra, is but one example of the confusion loose judicial statements engender. See, e.g., E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 77-81 (1972); Cary, Federal Minimum Standards, supra note 2; Cary, Federalism and Corporate Law, supra note 2; Shreiber & Yoran, Allocation of Corporate Opportunities by Management, 23 WAYNE L. REV. 1355 (1977). Inexplicably, Professor Folk did not treat the business judgment rule in his discussion of § 141(a) of the Delaware General Corporation Law, which imposes on directors the duty of managing or directing the management of the corporation’s business and affairs; rather, he dealt with the business judgment rule in his discussion of § 144 of the Delaware General Corporation Law, the subject matter of which, interested director transactions, is outside the scope of the business judgment rule. E. FOLK, supra, at 75-81.


the law clearly indicate the extent of protection afforded directors against liability for good faith mistakes in judgment and for business decisions that prove unpopular with one or more stockholders. The recent spate of decisions involving the authority of disinterested directors to preclude derivative actions has produced a renewed concern for the business judgment rule and highlights the need for a clearer understanding of its purpose and operation.

Even its worst detractors would, I suppose, admit that the fundamental premises underlying the business judgment rule are salutary. Those premises are simply that, as human beings, directors are not infallible and are not able to please all of the stockholders all of the time. The first premise recognizes human nature, the second the need to foster both business and judicial economy by not allowing every corporate transaction to be subject to judicial review at the request of a disagreeing stockholder.

8. See, e.g., Burks v. Lasker, 441 U.S. 471 (1979), rev'd 567 F.2d 1208 (2d Cir. 1978); Lewis v. Anderson, [current] FED. SEC. L. REP. (CCH) ¶ 97,153 (9th Cir. Oct. 29, 1979); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), cert. denied, 46 U.S.L.W. 3436 (U.S. Jan. 8, 1980); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978); Miller v. American Tel. & Tel. Corp., 507 F.2d 759 (3d Cir. 1974); Lewis v. Adams, No. 77-266C (N.D. Okla. Nov. 15, 1979); Galef v. Alexander, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,758 (S.D.N.Y. Jan. 24, 1979); Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973 (S.D.N.Y. 1978); Gall v. Exxon, 418 F. Supp. 508 (S.D.N.Y. 1976); Siegal v. Merrick, No. 77-Civ. 24-75 (CBM) (S.D.N.Y. Oct. 24, 1974); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). Subsequent to the writing of this Article, the Delaware Chancery Court in Maldonado v. Flynn, No. 4800 (Del. Ch. Mar. 18, 1980), declined to follow the preceding cases. The court held that a determination by a committee of independent, disinterested directors to terminate a derivative action against other directors to recover for alleged breach of fiduciary duty furnished no basis for dismissing the action. In denying the defendant corporation's motion to dismiss, the court reasoned that, due to the history and nature of derivative actions, once a corporation has refused to bring the action there rests in a stockholder an independent right to seek redress on behalf of the corporation for the alleged wrong, and it is beyond the directors' authority to compel dismissal of the action. Therefore, the business judgment rule was held to be irrelevant to the issue presented by the motion to dismiss.

9. See, e.g., Godbold v. Branch Bank, 11 Ala. 191 (1847); Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829).

The importance of the business judgment rule for the current deliberations over corporate governance does not lie only in the rule's simple recognition that directors ought not be liable for honest mistakes of judgment or unpopular business decisions. Its significance lies also in the limitations to its availability as a defense to liability and the standard of directorial conduct those limitations establish.

Far from constituting a shield from liability for fraud, mismanagement, or reckless decisions, the limitations on the business judgment rule's application impose significant duties on a director in the performance of his or her office. If the business judgment rule has at times appeared to excuse deplorable behavior, it has not been because the rule licenses such behavior, but because in such instances either the plaintiff failed to establish the facts necessary to make the defense inapplicable or the then-prevailing standards of conduct did not warrant, in the eyes of the court, the imposition of liability under the developed facts. In the final analysis, whether the standard of conduct is imposed by common law through limitations on the business judgment rule defense or by statute, liability of directors for their conduct in specific instances depends largely on prevailing business practices and on the trier of

11. See authorities note 2 supra.

12. By way of illustration, the gratuitous services of directors were once of concern to courts. See, e.g., Briggs v. Spalding, 141 U.S. 132 (1891); Citizens Building Ass'n v. Coriell, 34 N.J. Eq. 383 (1881); Spering's Appeal, 71 Pa. 11 (1872). However, the absence of compensation is not viewed as a mitigating factor in determining a director's liability or the standard of care required of that director. See Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (1901); W. Fletcher, Cyclopedia of the Law of Private Corporations § 1031 (rev. perm. ed. 1975).

fact's perception of what conduct conforms to the common law or statutory standard. Although that subjective standard may distress some corporate law reformers, it is as necessary in assessing the liability of a director for the consequences of his or her business decisions as it is, for example, in assessing the liability of a doctor, lawyer, or any other professional for the consequences of his or her professional decisions. Indeed, the primary function of the business judgment rule may be simply to accord to directors the same necessary protection that professionals enjoy under Anglo-American tort law if sued for malpractice.

**Genesis of the Rule**

The business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge. Both this purpose and the limits of the business judgment rule find perhaps their earliest American expression in *Percy v. Millaudon*, supra, an 1829 Louisiana Supreme Court decision involving the liability of bank directors for losses resulting from defalcations by the bank's president and cashier. In a discourse as relevant today as 150 years ago, the court articulated what we now generally conceive as the business judgment rule:

> It is no doubt true that if the business to be transacted presupposes the exercise of a particular kind of knowledge, a person who would accept the office of mandatory, totally ignorant of the subject, could not excuse himself on the ground that he discharged his trust with fidelity and care. . . . But when the person who was appointed attorney-in-fact, has the qualifications necessary for the discharge of the ordinary duties of the trust imposed, we are of opinion that on the occurrence of difficulties, in the exercise of it, which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions. The reason given for the rule, namely, that if the mandatory had not accepted the office, a person capable of discharging the duty correctly would have been found, is quite unsatisfactory. The person who would have ac-

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14. 8 Mart. (n.s.) 68 (La. 1829).
cepted, no matter who he might be, must have shared in common with him who did the imperfections of our nature, and consequently must be presumed just as liable to have mistaken the correct course. The test of responsibility, therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the agent is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it. The rule which fixes responsibility, because men of unerring sagacity are supposed to exist, and would have been found by the principal, appears to us essentially erroneous.15

A similar expression of the business judgment rule is found in Godbold v. Branch Bank,16 an 1847 Alabama Supreme Court decision. There, the bank’s board of directors had appointed a fellow director as agent for the bank to collect money and attend to certain bank affairs.17 As compensation for such extra service, the board voted to pay the director an additional $500 per year. It was subsequently determined that the director’s employment as agent was unlawful and suit was brought against one of the authorizing directors to recover the amount of the unlawful payments.18 In absolving the director of liability predicated on his misunderstanding of the law, the court explained the business judgment rule:

The undertaking implies a competent knowledge of the duties of the agency assumed by them, as well as a pledge that they will diligently supervise, watch over, and protect the interests of the institution committed to their care. They do not in our judgment undertake that they possess such a perfect knowledge of the matters and subjects which may come under their cognizance, that they cannot err, or be mistaken, either in the wisdom or legality of the means employed by them. To exact such extreme accuracy of knowledge from this or any other class of agents, to whom of necessity a large discretion in the choice of means must be entrusted, would be manifestly wrong, as it must frequently happen, that after the utmost circumspection and caution, the best possible course would not be pursued, and a loss be sustained, which as the event would show, might have been avoided. The inevitable tendency of such a rule, would be hostile to the end proposed by it, as no man of ordinary prudence would accept a trust surrounded by such perils.19

15. Id. at 77-78.
16. 11 Ala. 191 (1847).
17. Id. at 196.
18. Id. at 199.
19. Id.
One last early case, *Hodges v. New England Screw Co.*,\(^{20}\) bears mention. In an effort to salvage the New England Screw Company, its directors caused New England to purchase stock in another company. It then forced that company to lend money and extend credit to New England.\(^{21}\) Although the court found that the directors had undertaken the transaction in utmost good faith and for what they believed to be New England's best interests, their actions violated the company's charter, which did not authorize the holding of stock in other corporations.\(^{22}\) In refusing to hold the directors liable for the losses occasioned by the transaction, the court made the following observation about the directors' liability for errors in judgment:

In considering the question of the personal responsibility of the directors, therefore, we shall assume that they violated the charter of the Screw Company. The question then will be, was such violation the result of mistake as to their powers, and if so, did they fall into this mistake from want of proper care, such care as a man of ordinary prudence practices in his own affairs. For, if the mistake be such as with proper care might have been avoided, they ought to be liable. If, on the other hand, the mistake be such as the directors might well make notwithstanding the exercise of proper care, and if they acted in good faith and for the benefit of the Screw Company, they ought not to be liable.\(^{23}\)

The court reiterated that standard in simpler form three years later: "We think a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake."\(^{24}\)

I have quoted at length from these early cases not simply for their significant historical interest, but because they express quite clearly both the logic and the limits of the business judgment rule. In essence, each court held that a director who dutifully attends to his or her duties will not be personally liable for good faith business decisions. The rule is a necessary recognition of human fallibility. Courts have further justified the rule by a desire to conserve judicial resources by not permitting every business decision to be

\(^{20}\) 1 R.I. 312 (1850).
\(^{21}\) *Id.* at 342.
\(^{22}\) *Id.* at 346-47.
\(^{23}\) *Id.* at 346.
reviewed in court\textsuperscript{25} and by recognizing that business decisions frequently entail risk.\textsuperscript{26} However, the principal genesis of the business judgment rule—human fallibility—remains the same.

In addition, the early cases are interesting because they clearly emphasize the reasonable diligence and care demanded of a director in the performance of his or her duties. The business judgment rule was not conceived as a defense that, once asserted, precluded judicial inquiry into the procedures and methodologies followed by the directors in making their challenged decision. In none of the three cases was the court prepared to excuse directors on the strength of their bare judgment exercised in good faith but without due care. Instead, in each case the business judgment rule was a starting point for inquiry into the directors' decisionmaking process.

As an abstract proposition of law, the business judgment rule remains remarkably the same today as it was 150 years ago in \textit{Percy}.\textsuperscript{27} The question that remains is why, if the rule was clear in 1829, is it today so frequently misstated by both its detractors and its more ardent supporters to suggest that the rule constitutes an impenetrable shield to liability.

\textbf{Genesis of the Confusion}

Some advocates of federal chartering of corporations or the enactment by Congress of federal standards of directorial conduct have seized upon the business judgment rule to support the thesis that state law in the area of corporate governance is too lax and that federal legislation is necessary to assure adequate standards of directorial conduct. For example, Ralph Nader, in his report urging federal chartering,\textsuperscript{28} states that in Delaware the business judgment rule has evolved into an absolute bar against judicial scrutiny of mergers, parent-subsidiary relations, sales of assets, stock option plans, stock repurchases, and other fundamental transactions absent a showing of "gross and palpable overreaching," fraud, or self-dealing.\textsuperscript{29} Similarly, Professor William Cary, advo-

\begin{footnotesize}
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\item \textsuperscript{25} See cases note 10 supra.
\item \textsuperscript{28} R. NADER, M. GREEN & J. SELIGMAN, supra note 2.
\item \textsuperscript{29} Id. at 145.
\end{itemize}
\end{footnotesize}
ating a federal corporate minimum-standards act, defines the Delaware business judgment rule as one in which a court will not interfere with a business judgment decision absent "gross and palpable overreaching." Mr. Nader's and Professor Cary's articulations of the Delaware business judgment rule may well have been influenced by Professor Ernest Folk's analysis of two Delaware Supreme Court cases that dealt with the business judgment rule. According to Professor Folk, the effect of these cases is to remove most transactions within corporate families from effective judicial scrutiny and to put a heavy burden on a plaintiff either to establish self-dealing before the courts will look for fairness or, if he cannot point to self-dealing, then to meet the nearly impossible test of a "showing of gross and palpable overreaching."

The confusion exemplified by the foregoing criticisms of the business judgment rule results primarily from the repetition of statements made by courts without due concern for the context in which they originally appeared. The result is an appearance of low standards of directorial and controlling stockholder conduct, which is unsupported by the factual circumstances in which the statements appear.

As the decision in Percy v. Millaudon attests, the confusion with respect to the scope and operation of the business judgment rule began early. In Percy, where it was determined that the directors had exercised sufficient care, the court indicated that liability could be established "by showing that the error of the agent is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it." Since "common sense" and "ordinary attention" should suffice to allay any suspicion that the "gross" error of which the court spoke would involve only the most

32. E. FOLK, supra note 5, at 80-81 (1972). Professor Folk's statement is, on its face, self-contradictory. "[M]ost transactions within corporate families," which, he says, are removed "from effective judicial scrutiny," are, almost by definition, "self-dealing" transactions, that will be sustained only if the parties who controlled the fixing of the terms sustain the burden of persuading the court that the terms were intrinsically fair. See text accompanying notes 96-99 infra.
33. See text accompanying notes 37-71 infra.
34. 8 Mart. (n.s.) 68 (La. 1829).
35. Id. at 78.
imprudent acts imaginable, the word "gross" adds nothing and invites misconstrual. Had the court substituted "such" for "of so gross a kind" the meaning of the sentence would not have changed.

The Delaware courts have contributed to the contemporary misunderstanding surrounding the business judgment rule by characterizing the "gross and palpable overreaching" standard as a "business judgment" test. This standard has only been applied to those parent-subsidiary transactions where a determination of fairness is meaningless or impossible because such transactions are never entered into by unrelated parties dealing at arm's length. The first Delaware case to equate business judgment with the "gross and palpable overreaching" standard was Meyerson v. El Paso Natural Gas Co., decided by the court of chancery in 1967. Meyerson was a derivative action by a minority stockholder of an El Paso subsidiary, of which El Paso held more than eighty percent of the stock. Plaintiff sought an accounting from El Paso for alleged unjust enrichment flowing from tax savings that resulted from consolidated income tax returns in which the subsidiary's tax losses were offset against El Paso's taxable income. Since Meyerson involved the fiduciary duty of a parent corporation to the minority stockholders of its subsidiary, the court held that the test to be applied to the transactions was one of fairness, which is the test usually applied where the business judgment rule is not applicable. However, the court in Meyerson was concerned by the absence of a standard by which to determine what a fair allocation of the tax savings would be:

What then would be a fair allocation? . . . [I]t is impossible, as between parent and subsidiary, to set fair standards for [tax] allocation agreements. Nor does this impossibility justify allocating the entire amount of tax savings to the loss-subsidiary, particularly where it appears, as here, that the subsidiary itself could not, in all probability, have ever availed itself of the use of the loss. The question, then, is reduced to one of business judg-

36. And, indeed, Percy was described as holding that "directors are not liable for errors of judgment unless they are grossly wrong." 3 W. COOK, A TREATISE ON THE LAW OF CORPORATIONS § 703, at 2855 n.3 (8th ed. 1923).
37. 246 A.2d 789 (Del. Ch. 1967).
38. Id. at 790.
ment with which the court should not interfere absent a showing of 'gross and palpable overreaching.' No such showing is here made."\(^{40}\)

Concluding that the plaintiff in Meyerson had failed to show "gross and palpable overreaching," the court denied his motion for summary judgment.\(^{41}\)

The "gross and palpable overreaching" phrase seized upon by the court in Meyerson was drawn from a dissenting opinion in Case v. New York Central Railroad Co.,\(^{42}\) a case decided in the New York state courts and summarized in Meyerson as follows:

Case v. New York Central Railroad Company . . . was a minority stockholder's action which challenged the fairness of an allocation agreement whereby tax savings resulting from the filing of consolidated income tax returns could be allocated almost exclusively to the parent corporation. The Supreme Court of New York, Trial Term, dismissed the complaint on the ground that the agreement was not unfair to minority stockholders of the subsidiary. On appeal, the Appellate Division reversed the judgment of the trial court and entered judgment requiring the parent to account to the subsidiary for all of the tax savings retained by the parent. After noting that the parent stood in a fiduciary relationship to the subsidiary's minority stockholders, the Appellate Division held that the allocation agreement insofar as it permitted the total appropriation of the tax savings to the parent was unfair. In the course of its opinion the court recognized 'the inevitable fact that there cannot be effective independent bargaining among affiliates.' Except to say that total appropriation was unfair the court gave no indication of what allocation it would have considered to be fair. Two justices of the court dissented saying: 'Even if there were an arm's length transaction, it would be extremely difficult, if not impossible, to determine what would be fair . . . Traditionally, what is fair is what these two parties would agree on. But actually in such a situation the terms of agreement would depend almost entirely on the bargaining ability and the personal characteristics of the parties. Such factors defy the making of an estimate of the result that would be reached . . . When the factor is added that this agreement could not be made by disinterested parties, it must be the rule that anything short of gross and palpable overreaching does

\(^{40}\) 246 A.2d at 794 (emphasis added).

\(^{41}\) Id.

not warrant court interference.' On appeal from the judgment of
the Appellate Division the Court of Appeals of New York re-
versed and reinstated the judgment of the trial court. The Court
of Appeals, in effect, adopted the reasoning of the dissent in the
Appellate Division, observing that the 'majority felt itself unable
to say what would be a fair proportion of the distribution of Cen-
tral’s tax loss looking forward from the date of judgment.' In con-
clusion the court said: ‘No such faithlessness of the majority of
Mahoning [Central’s subsidiary] directors to its corporate inter-
est has been demonstrated as to warrant judicial interference
with the challenged corporate decision.’

Although the court in Meyerson linked the phrase “business judg-
ment” to the “gross and palpable overreaching” standard that was
applied, it is evident from the whole opinion that the court was
not, as a general proposition, immunizing conduct by a controlling
stockholder or directors that fell short of “gross and palpable over-
reaching.” Instead, like the courts in Case v. New York Central, it
was addressing the narrow question of what standard was appli-
cable to a review of those parent-subsidiary transactions which by
their nature could not be subjected to a fairness inquiry.

In Getty Oil Co. v. Skelly Oil Co., decided in 1970, the
Delaware Supreme Court followed the lead of the court in Mey-
erson, continuing to equate the “gross and palpable overreaching”
standard with a rule of business judgment. The facts in Getty were
simple. Getty and Skelly were both integrated oil companies with
public stockholders. Getty owned seventy-one percent of Skelly
stock, sufficient to elect the entire Skelly board. Before 1967, Getty
and Skelly each received its own oil import allocation under the
federal mandatory oil import program. Each company’s allocation
was based solely on its own past use of imported oil. In 1967, the
federal administrator stopped awarding allocations to Skelly be-
cause it was controlled by Getty and continued to award allocations
to Getty based solely on Getty’s own prior use. Getty decided
not to share its allocations with Skelly and subsequently sought a

43. 246 A.2d at 792 (emphasis added) (citations omitted).
44. 19 A.D.2d 383, 243 N.Y.S.2d 620 (1st Dep’t 1963), rev’d, 15 N.Y.2d 150, 204
46. Id. at 884-86.
47. The administrative determination that Skelly was a controlled corporation
and thereby ineligible for separate oil allocations was affirmed in Skelly Oil Co. v.
(D.C. Cir. 1970).
declaratory judgment stating that Getty was not obligated to share its allocations with Skelly. Relying upon Meyerson, Getty asserted that its decision to retain the entire allocation for itself should not be set aside absent a showing of gross and palpable overreaching.

The Delaware Chancery Court declined to apply the "gross and palpable overreaching" standard and instead applied a fairness test, equating the nontransaction between the two related corporations with an actual transaction between them in which the majority stockholder had dealt unfairly with its controlled subsidiary. On that basis, the court adjudged that Getty must share its oil allocation with Skelly. The Delaware Supreme Court reversed, holding that Getty's fiduciary duty to its subsidiary did not require self-sacrifice from Getty. However, instead of clearly resting the decision on the nondebatable ground that the mere status, without more, of majority stockholder does not require the majority stockholder to assist its less than wholly owned subsidiary, the court, citing Meyerson, held that Skelly had failed to show "gross and palpable overreaching," which would warrant judicial interference. As in Meyerson, however, Getty involved a parentsubsidiary transaction (actually, a nontransaction) that was not susceptible to a fairness analysis.

The Delaware Supreme Court's decision in Sinclair Oil Corp. v. Levien also repeated the "gross and palpable overreaching" standard in the context of a parentsubsidiary transaction. Plaintiff in Sinclair sued derivatively claiming that Sinclair, owner of ninety-seven percent of the stock of Sinven, the corporation in which plaintiff was also a stockholder, had caused Sinven to pay excessively generous dividends, thereby preventing Sinven from significantly expanding its operations as would have been possible had its dividends been smaller. Plaintiff, as had Skelly in Getty, claimed breach of fiduciary duty, and Sinclair's defense was that the question of whether or not Sinven should pay dividends, and if

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48. 255 A.2d at 720-21 (Del. Ch. 1969). The court distinguished Meyerson, where it noted that a fairness determination was impossible, from the Getty-Skelly situation, where an apportionment formula approximating "what fair arm's-length bargaining would probably have yielded" was available. Id. at 721.
49. Id. at 722.
50. 267 A.2d at 888.
51. Id. at 887-88 (citing Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, 794 (Del. Ch. 1967)).
52. 280 A.2d 717 (Del. 1971).
53. Id. at 722.
54. Id. at 720-21.
so how much, was covered by the business judgment rule.\textsuperscript{55} Again, the Delaware Chancery Court disagreed with the controlling stockholder’s claim that the business judgment rule was applicable. It held that because Sinclair admittedly dominated the subsidiary’s board of directors, which distributed the criticized dividends, the appropriate test was one of fairness, with Sinclair having the burden of proof.\textsuperscript{56} Finding that Sinclair had failed to meet its burden of showing that its action in causing Sinven to pay these dividends was fair, the chancery court ordered Sinclair to account to Sinven for its damages sustained as a result of the dividend policy.\textsuperscript{57} The Delaware Supreme Court reversed, holding that the payment of a dividend in which all stockholders shared prorata is not a self-dealing transaction between a corporation and its controlling stockholder and, therefore, the question of whether the dividends were greater than they should have been is governed by the business judgment rule.\textsuperscript{58}

Unfortunately, having reached that conclusion, the court proceeded to refer to no less than three ostensible business judgment standards in various parts of its opinion. First, in summarizing Sinclair’s argument and its reliance on \textit{Meyerson}, the court stated:

\begin{quote}
Sinclair argues that the transactions between it and Sinven should be tested, not by the test of intrinsic fairness with the accompanying shift of the burden of proof, but by the business judgment rule under which a court will not interfere with the judgment of a board of directors unless there is a showing of gross and palpable overreaching. A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.\textsuperscript{59}
\end{quote}

Thus, in successive sentences, the court linked both “gross and palpable overreaching” and “rational business purpose” to the business judgment rule.\textsuperscript{60} However, in doing so, the court may have been only stating Sinclair’s argument and not its own view of the

\begin{thebibliography}{99}
\bibitem{55} Id.
\bibitem{56} 261 A.2d at 916.
\bibitem{57} Id. at 921.
\bibitem{58} 280 A.2d at 721-22.
\bibitem{59} Id. (citations omitted).
\bibitem{60} The court’s statement that a board’s “decisions will not be disturbed if they can be attributed to any rational business purpose,” \textit{id.}, has been a source of confu-
\end{thebibliography}
Later in the opinion, the court suggests that the rule was applicable only if the challenged conduct was grounded on a “reasonable business objective.” The court said: “If a plaintiff can meet his burden of proving that 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.”

Finally, in concluding that Sinclair was not liable for having caused Sinven to pay dividends that prevented Sinven from expanding its business when other wholly owned Sinclair subsidiaries were expanding theirs, the court said the business judgment rule was applicable “absent fraud or gross overreaching”:

Since there is no proof of self-dealing on the part of Sinclair, it follows that the expansion policy of Sinclair and the methods used to achieve the desired result must, as far as Sinclair’s treatment of Sinven is concerned, be tested by the standards of the business judgment rule. Accordingly, Sinclair’s decision, absent fraud or gross overreaching, to achieve expansion through the medium of its subsidiaries, other than Sinven, must be upheld.

The court’s statement that, in the absence of self-dealing, it would not interfere with the decisions of Sinclair and of Sinven’s directors to pay the criticized dividends unless plaintiff could show that such decisions were not grounded on any “reasonable business objective” or “rational business purpose” is, in this writer’s view, a correct articulation of one element of the business judgment rule. It should be assumed that a business objective or purpose is reasonable or rational only if its accomplishment is intended to serve the corporation’s best interests. On the other hand, the court’s repeated references to Meyerson and its linkage of the “gross and palpable overreaching” standard to the business judgment rule should be viewed only as a further application of the “gross and palpable overreaching” standard to that narrow class of parent-subsidiary transactions where an arm’s-length fairness test cannot be applied, and not as a definition of the business judgment rule to be given general application.

sion and criticism. It has been claimed that this formulation of the business judgment rule puts upon a stockholder “the seemingly impossible task of proving ‘irrationality.’” See E. FOLK, supra note 5, at 78. “Irrational” is an antonym of “rational.” However, “reasonable” and “reasoning” are synonyms of “rational,” and in view of the later reference in Sinclair to “reasonable business objective,” it is clear that it is in this sense that the Delaware Supreme Court used “rational.”

61. 280 A.2d at 721.
62. Id. at 722.
In short, given the historical origin and limited application of the "gross and palpable overreaching" standard, it is this writer's belief that such standard properly has application, if at all, only in the narrow circumstances presented when dealing with some parent-subsidiary relationships; that is, in those special situations where a fairness determination is impossible due to the absence of any criterion by which to judge the fairness of the challenged transaction. Thus, the "gross and palpable overreaching" standard should not be considered an element of, or confused with, the business judgment rule as applied generally.

Fortunately, there are decisions of the Delaware courts, both before and after Meyerson, Getty, and Sinclair and apart from the narrow context of those cases, that do not refer to the "gross and palpable overreaching" standard in describing the business judgment rule. In Bodell v. General Gas & Electric Corp., the Delaware Supreme Court stated the business judgment rule succinctly and comprehensively: "If in the particular case there is nothing to show that the directors did not exercise their discretion for what they believed to be the best interest of the corporation, certainly an honest mistake of business judgment should not be reviewable by the Court." The court held that so long as "the acts of the directors objected to were performed in good faith, in the exercise of their best judgment, and for what they believed to be the advantage of the corporation and all its stockholders," the acts will not be enjoined or the directors held personally liable. The court further held that "fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders" will strip the directors' actions of the protection of the business judgment rule.

In Warshaw v. Calhoun, a 1966 Delaware Supreme Court decision, the business judgment rule was defined as follows:

In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of directors will not be interfered with by the courts. The burden of showing the existence of bad faith or abuse of discretion rests upon the plaintiff who charges that the corporate action was

63. 15 Del. Ch. 420, 140 A. 264 (Sup. Ct. 1927).
64. Id. at 426, 140 A. at 267.
65. Id. at 429-30, 140 A. at 268.
66. Id. at 427, 140 A. at 267.
taken to benefit the majority at the expense of the minority. The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation, and a minority stockholder who challenges their bona fides of purpose has the burden of proof.

Similarly, in Chasin v. Gluck, a 1971 Delaware Chancery Court decision rendered after Sinclair and Getty, the court stated that, absent self-dealing, director defendants charged with responsibility for corporate losses injurious to minority stockholders should not be held accountable unless plaintiff could show that they were guilty of "bad faith, negligence, or gross abuse of discretion." While issue may be taken with the use of the word "gross" to modify the term "abuse of discretion," it is submitted that Bodell, Warshaw, and Chasin do accurately set forth the basic elements of the business judgment defense without any reference to the "gross and palpable overreaching" standard.

That neither the Delaware Supreme Court nor the Delaware Chancery Court has attributed to the Getty and Sinclair cases the broad immunizing effect that has been attributed to them by those who would replace state corporate law with federal corporate law is illustrated by a number of subsequent decisions. Gimbel v. Signal Companies, Inc., and Thomas v. Kempner are of particular interest.

In Gimbel, a Signal stockholder sued to enjoin the sale by Signal of a wholly owned subsidiary to an unaffiliated buyer for $480 million. The sale, which did not require stockholder approval, had been approved by Signal's board of directors at a special meeting and was soon to be consummated. Because there was no personal interest or self-dealing, the court examined the transaction with the presumption in favor of the directors that they had negotiated the sale honestly and had secured terms and conditions believed to be expedient and in the corporation's best interests. The court acknowledged that the facts would not support the con-

68. Id. at 157-58, 221 A.2d at 492-93 (citations omitted).
69. 282 A.2d 188 (Del. Ch. 1971).
70. Id. at 192-93 (citing Warshaw v. Calhoun, 43 Del. Ch. 148, 221 A.2d 487 (Sup. Ct. 1966)).
71. See text accompanying notes 34-36 supra.
75. 316 A.2d at 608-09.
clusion that the directors had acted so far without information that they could have been said to have passed an unintelligent and unadvised judgment.\textsuperscript{76} If the business judgment rule precluded intervention absent proof of irrationality or gross and palpable over-reaching, the chancery court's inquiry would have ended there. But it did not. The court preliminarily enjoined the proposed transaction because there was sufficient disparity between the sale price and what plaintiff's proof showed was the fair value of the property being sold to raise serious questions about whether the directors had acted outside the bounds of reason or recklessly in approving the sale price,\textsuperscript{77} a question to be answered after trial.

Of equal significance is the Delaware Chancery Court decision in \textit{Thomas v. Kempner}.\textsuperscript{78} This was an action by a stockholder to enjoin a sale by the defendant, Sugarland Industries, Inc., of its principal asset, 7,500 acres of farmland.\textsuperscript{79} Serious efforts had been made to dispose of the land, and after several years an agreement in principal was reached which, if consummated, would have resulted in the receipt by the corporation of $23,800,000. In the interim, however, a second purchaser came upon the scene and offered $27,000,000 for the property on the same terms.\textsuperscript{80} Plaintiff charged the defendant corporation's board of directors with improperly shutting their eyes to a better offer. No personal interest or self-dealing was involved; nonetheless, the transaction was preliminarily enjoined, on the following basis:

\begin{quote}
[T]he fundamental error of business judgment on the part of the director defendants in this case, which has led to the present impasse and provoked a need for injunctive relief, was their insistence in continuing to deal solely with White and Hill in mid-February 1973, after it was readily apparent that at least one other group was not only interested in acquiring the Sugarland's lands here in issue but was willing to top White and Hill's offer as to cash. In other words, at a time when Sugarland was about to be put into a dissolution receivership, which when ultimately accomplished will mean that the defendant directors or some of them will be deemed trustees, corporate action was proposed which appears to have been designed to obtain less than the maximum price available for corporate assets because the principal of competitive bidding was ignored.\textsuperscript{81}
\end{quote}

\textsuperscript{76} \textit{Id.} at 615.

\textsuperscript{77} \textit{Id.} at 617-18.

\textsuperscript{78} No. 4138 (Del. Ch. Mar. 22, 1973).

\textsuperscript{79} \textit{Id.}, slip op. at 1-2.

\textsuperscript{80} \textit{Id.}, slip op. at 7.

\textsuperscript{81} \textit{Id.}, slip op. at 11-12 (citations omitted).
So much for the impenetrable shield of the business judgment rule.  

**THE RULE STATED**

Courts and commentators alike have attempted various formulations of the business judgment rule, typically that a director who diligently attends to his or her duties and exercises his or her best business judgment on the questions facing the board will not be held liable even if the judgment is faulty. Such formulations are, perhaps, too compact and convey too little of the rule's limitations as a defense. Thus, at the risk of repetition, and perhaps of engendering some disagreement, the following statement of the business judgment rule is proffered:

A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damages, unless:

1. the directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or

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82. See also Maldonado v. Flynn, No. 4800 (Del. Ch. Mar. 18, 1980) (after stockholders commence derivative action, directors lack authority to terminate litigation).


84. Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944); Lewis, supra note 83, at 158.

85. The rule is stated only in terms of directors, but extends to corporate officers as well. Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Kelly v. Bell, 254 A.2d 62, 75 (Del. Ch. 1969), aff'd, 266 A.2d 878 (Del. 1970). To the extent a majority or controlling stockholder usurps the function of the board of directors by influencing or directing the directors' decision, such stockholder may have the benefit of the business judgment rule. Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 64, 73, 120 A. 486, 491 (Ch. 1923). In either case, the same limitations on the availability of the business judgment rule defense are applicable.
(2) the directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or

(3) in some other way the directors' authorization of the transaction was not in good faith.

Omitted as redundant is a statement of the presumption accorded by the courts to directors that their conduct satisfies the rule.86

This expression of the business judgment rule embodies both the substance of the rule itself and the principal limitations on its availability as a defense. Implicit in this statement of the rule is that there be an affirmative directorial judgment.87 Where the charge is that by reason of inexcusable unawareness or inattention the directors failed to take corrective or preventive action toward matters about which something should have been done to prevent harm to the corporation or its stockholders, the business judgment rule provides no defense. Such a charge involves the failure to act, not the exercise of any judgment.88 In such cases, the appropriate inquiry is simply whether the directors acted with the degree of care required of them in the discharge of their duties. But having made no deliberate decision, the defense that directors are not liable for honest mistakes of judgment is not available in such cases. Deal v. Johnson89 is demonstrative.

In Deal, a trustee in bankruptcy sued the president and other directors of Covington Grain Company to recover losses suffered by the corporation as a result of the president's speculation in grain futures.90 Although the court ostensibly applied a "gross negligence" test,91 the evidence was more than adequate to support the

86. For a discussion of the operation of the presumption, see text accompanying notes 168-181 infra.


89. 362 So. 2d 214 (Ala. 1978).

90. Id. at 216.

91. Id. at 218. Looking back to Godbold, see text accompanying notes 16-19.
judgment if a simple negligence standard had been used. The principal thrust of plaintiff's case was that the defendant directors would have known of the president's speculation in grain futures if they had properly informed themselves of the corporation's business affairs.92 The defendants were absolved of liability, however, after demonstrating the following facts: At an annual meeting of stockholders and directors, the company's annual financial statement was presented and explained by the company's outside independent accountants. The directors raised questions about certain commodities contracts, and the president explained that they were purchased to protect the company's position and were not speculative. The directors and the company's accountant warned the president not to engage in any speculation, and the president assured them that he would not. The president had been a responsible businessman in the community for many years and there was no reason to doubt his integrity. The outside accountant indicated to the directors that there was no reason, based on his examination, to order a special audit. The plaintiff's own commodities experts testified that they would have been unable to detect speculative commodities contracts had they been asked to examine the company's books and records; only a certified public accountant could have uncovered such speculations as it was beyond an ordinary businessman's ability to detect.

The evidence in Deal demonstrated that had the directors made an independent examination of the company's books and an examination into the character and truthfulness of the president, they would not have detected any speculative commodities contracts nor would they have found a reason to doubt the president's report. In short, having raised questions about the company's commodities contracts and having received a satisfactory response from the president, the directors had exercised requisite due care.

Deal did not, however, involve the business judgment rule defense. The directors were not absolved of liability because they had made an informed business decision; rather they had made no decision whatsoever except to rely upon the president's representations. If the business judgment rule is to be implicated at all in cases like this, it should only be to the limited extent that the di-

supra, one can only wonder where the Alabama courts found in the interim a "gross negligence" standard.

92. 362 So. 2d at 217.
rectors' decision to rely upon the representations of the company's president was the product of good faith business judgment.

The business judgment rule thus properly concerns only those instances in which a challenge is made to a transaction that the directors authorized or to their decision not to authorize or approve a transaction. Such challenges are made most often in a suit by a stockholder to enjoin a proposed transaction or to recover from directors damages allegedly suffered by the corporation as a consequence of a completed transaction. Sometimes, both forms of relief are requested alternatively in the same suit. In each case, the central issue should be whether the directors complied with the legal standards that courts apply to determine whether they have properly performed their duties. If such standards are met, the court should neither enjoin the transaction nor hold the directors personally liable.

Under this conception, the business judgment rule furnishes not only a defense to liability for honest mistakes of judgment, but also an outline for the relevant inquiries in determining whether the directors have conducted themselves in such manner as to be entitled to the defense. As such, the rule functions not to preclude inquiry but to guide it, for where a business decision of directors is challenged, the court must examine the evidence concerning the circumstances in which and the information on which the directors made their decision. This inquiry is made, not for the purpose of ascertaining whether the decision made was correct or one which the court would have made, but to ascertain whether the evidence does or does not establish that the directors exercised due care and believed, on a reasonable basis, that the challenged transaction was in the corporation's best interest.93

THE RULE IN OPERATION

Having phrased the business judgment rule in terms suggestive of an outline for an inquiry into whether the defense is available, it seems appropriate to make some observations concerning each element of the rule. In doing so, no pretense is made that every case applying the business judgment rule has been considered. Rather, the commentary that follows is intended only to highlight each element and its fundamental concerns.

Personal Interest Limitation—Duty of Loyalty

Some forty years ago, the Delaware Supreme Court in Guth v. Loft94 articulated the duty of loyalty owed by directors to the corporation they served:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.95

The “profound knowledge of human characteristics and motives,” from which was derived the public policy and duty of loyalty announced in Guth, requires also a recognition that where a director or controlling stockholder stands to benefit personally from the decision as a director or controlling stockholder, his or her business judgment is likely to be affected by personal interest. Indeed, the law presumes that in cases of personal interest or self-dealing the individual benefit, not the corporate best interest, will have governed the decision.96 Thus, where a director or controlling stockholder has a material personal interest in the outcome of a transaction or is engaged in self-dealing, it will fall to that individual to prove that the transaction he or she authorized is intrinsically fair to the corporation and its stockholders.97 Otherwise stated, where

94. 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).
95. Id. at 270, 5 A.2d at 510.
such a personal interest or self-dealing is shown to exist, a presumption of overreaching arises that can be overcome only by proof of intrinsic fairness. This has been denominated the intrinsic fairness rule.

There is no presumption that a challenged transaction either does or does not involve self-dealing or other personal interest that would affect the applicability of the business judgment rule defense. Therefore, the party challenging the transaction must prove self-dealing or personal interest to make the defense inapplicable. Self-dealing, in this context, means any attempt by a director or controlling stockholder to appropriate to himself or herself corporate assets other than prorata with other stockholders or a situation where a director or controlling stockholder stands on both sides of the transaction. While any instance of a director's self-dealing will make the business judgment rule defense inapplicable as to him or her, not every "personal interest" will have that effect. To remove business judgment as a defense, the director's "interest" in the transaction must be tantamount to self-dealing or the transaction must be one in which he or she personally receives some tangible benefit not received by the corporation itself or by all stockholders prorata, for which personal benefit he or she does not personally give consideration of commensurate value. The assertion by a complaining stockholder of a director's personal interest may cause the court to examine more critically the evidence offered by the director, but unless the plaintiff proves personal interest of the required character, the director will have the benefit of the business judgment rule defense. Whether in a given instance a director's personal interest will preclude the business judgment defense will depend upon the nature and degree of the interest, and courts have often differed as to whether the demonstrated personal interest affects the availability of the business


101. See cases note 97 supra.
judgment defense. For example, does a director's ownership of stock in the corporation of which he or she is a director constitute a vitiating personal interest in a merger or sale of assets? If through such stock ownership a director is able to personally secure either the whole or any part of the corporate assets other than on a prorata basis with all other stockholders, it does. If, however, the effects of the transaction fall equally on all stockholders, the collateral personal advantage gained by the director will not necessarily eliminate the business judgment defense.

An analogous personal interest in a transaction may arise where a director who is also an employee will continue in that or a similar capacity after the corporation is sold to or merged with another company. It has been suggested that the continuance of such a director in a similar capacity with the purchaser or survivor corporation will not destroy the presumption of good faith business judgment. Those statements may be overly broad. If the continuance of employment is not prearranged and made a condition of the transaction by the director, and if there is no significant personal gain in the form of prearranged increased compensation, the "personal benefit" of continued employment for which the director renders services commensurate in value to the compensation does not deprive the director of the business judgment defense. However, where the director makes his or her continued employment by the purchaser or survivor corporation a condition to the transaction, or significant and direct personal benefit is derived from it in the form of increased compensation or other payment, the director receiving such benefit should not be protected by the business judgment defense.

The mere ability to control, as opposed to the actual exercise


107. Id.
of control, also will not vitiate the business judgment rule defense, nor will the mere existence of interlocking boards of directors.\textsuperscript{108} Rather, an actual manipulation or exercise of control must be shown before the benefits of the business judgment rule are lost. Illustrative is \textit{Puma v. Mariott},\textsuperscript{109} where the court sustained Mariott Corporation’s purchase of all the stock of six companies principally owned by members of the Mariott family, who owned forty-four percent of Mariott’s outstanding stock.\textsuperscript{110} Plaintiff alleged that the case involved insiders dealing with their corporation, and thus the proper standard by which to judge the transaction was intrinsic fairness. The court disagreed, noting that although the Mariott family owned forty-four percent of the stock, plaintiff had failed to show that the Mariott family dominated the outside directors, who constituted a majority of the whole board and had proposed and negotiated the transaction.\textsuperscript{111} Accordingly, the court refused to disturb the judgment of the outside directors, whose independence was unchallenged and who had valued the property of the companies to be acquired based upon appraisals, analyses, information, and opinions provided by independent experts, whose qualifications were unquestioned.\textsuperscript{112}

In summary, those directors whose judgment is untainted by any personal interest are entitled to the benefits of the business judgment rule. Moreover, their determination may have the further effect of insulating from liability interested directors, who in the absence of independent directors favoring the transaction would have the burden of establishing its intrinsic fairness. Where a complaining stockholder charges that a director has a personal interest, it is necessary for the court to assess the nature and degree of that interest to determine whether or not it eliminates business judgment as a defense.

\textit{Exercise Of Due Care}

Those who criticize the business judgment rule (for the most part, those who advocate replacing, in varying degrees, state corporate law with federal corporate law) frequently do so in the context of the standard of care that a director must exercise in the per-

\begin{footnotes}
\item[108] See, e.g., Kaplan v. Centex Corp., 284 A.2d 119, 122-23 (Del. Ch. 1971);
Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971).
\item[109] 283 A.2d 693 (Del. Ch. 1971).
\item[110] Id. at 696.
\item[111] Id.
\item[112] Id.
\end{footnotes}
formance of his or her duties, and generally on the ground that the standard is intolerably low. To so criticize the business judgment rule only highlights the misunderstanding that exists about the rule, for it equates the rule's standard-of-care element with the rule itself, which is not the case at all. The distinction is well framed in Casey v. Woodruff.  

The question is frequently asked, how does the operation of the so-called ‘business judgment rule’ tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.  

The business judgment rule thus only protects a director from the consequences of a decision if, among other things, the decision was made on the basis of all relevant facts, including those facts he or she should have known had due care been exercised. A director who does not take a reasonable amount of trouble acquire the relevant and available facts relating to a proposed transaction cannot


114. 49 N.Y.S.2d 625 (Sup. Ct. 1944).  

115. Id. at 643. This distinction has found some criticism. See M. Feuer, Personal Liabilities of Corporate Officers and Directors 19-22 (1961); Lewis, supra note 93, at 170. The objection is that the judgment is limited to diligence only, with no concern given to prudence, i.e., some modicum of intelligence. The court in Casey, however, called for “an honest, unbiased judgment . . . reasonably exercised.” 49 N.Y.S.2d at 643 (emphasis added). That a need for prudence exists is clearly illustrated in Barr v. Wackman, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975). See also Lutz v. Boas, 39 Del. Ch. 585, 608-10, 171 A.2d 381, 395-96 (Ch. 1961); Francis v. United Jersey Bank, 162 N.J. Super. 355, 369-71, 392 A.2d 1233, 1240-41 (Law Div. 1978), aff’d, 171 N.J. Super. 34, 407 A.2d 1253 (1979).  

defend the challenged action on the ground that he or she exercised business judgment. It is one thing to make a decision, and another thing to make an informed decision. It is only the latter type of decision that the business judgment rule protects.

The standard of care required of a director has been the subject of much able comment over the years, and it is not the purpose of this Article to settle the issue of the precise degree of care appropriate for directors. It is observed, however, that the standard of care required by courts does not, in Delaware or in most states, approach the abysmally low standards that many commentators have suggested. The essence of the modern cases and ex-
isting statutes on this subject is distilled in section 35 of the Model Business Corporation Act. Interestingly enough, the standard of care found in the Model Act is not appreciably different from the standard of care set forth in the early cases of Percy v. Milraudon, Godbold v. Branch Bank, and Hodges v. New England Screw Co.

Abuse Of Discretion

If a court determines that the directors' business decision is not the product of an honest exercise of sound judgment, the court will enjoin the transaction or hold directors liable for the conse-

able to do so,” Grill v. General Iron Screw Collier Co., 35 L.R.C.P. 321, 324-25 (1866). The majority view in America supports the standard set forth by the Delaware Supreme Court in Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963), that directors must “use that amount of care which ordinarily careful and prudent men would use in similar circumstances.” Id. at 84, 188 A.2d at 130. See ABA-ALI MODEL BUS. CORP. ACT § 35(b) (rev. ed. 1974); W. FLETCHER, supra, § 1035.

120. Paragraph 2 of § 35 of the Model Act reads as follows:

A director shall perform his duties as director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,

(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person’s professional or expert competence, or

(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which the committee the director reasonably believes to merit confidence, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

ABA-ALI MODEL BUS. CORP. ACT § 35 (rev. ed. 1974). For state statutes that have established minimum standards of directorial conduct, see note 12 supra. Failure to meet the negligence standard of § 35 of the Model Act prevents a director from meeting the standard for indemnification found in § 5(b) of the Model Act. See ABA-ALI MODEL BUS. CORP. ACT §§ 5(b), 35(b) (rev. ed. 1974); Committee on Corporate Laws, supra note 26. See also Arsh & Hinsey, Codified Standard—Same Harbor But Chartered Channel, 35 BUS. LAW. —. (No. 3 Apr. 1980).

121. 8 Mart. (n.s.) 68 (La. 1829). See text accompanying notes 14 & 15 supra.

122. 11 Ala. 191 (1847). See text accompanying notes 16-19 supra.

123. 1 R.I. 312 (1850). See text accompanying notes 20-24 supra.
quences to the corporation. This particular limitation to the business judgment rule is, perhaps, not a limitation at all, but simply an application of the fundamental principle behind the rule. An honest error in judgment is allowed. But a judgment that cannot be sustained on some rational basis falls outside the protection of the business judgment rule; the transaction's results may often belie the honest, good faith exercise of judgment.

It is true that if one goes far enough back in history, judicial statements can be found suggesting that if the subject matter of the decision is within the directors' discretionary powers and there is no taint of self-dealing or fraud, directors are not liable regardless of how poor or injurious their judgment may have been. But it may not be seriously contended that this is the state of the law as it exists today, or even as it has existed in this century.

Many cases involving this limitation center on the evaluation of corporate assets in the context of a merger or purchase or sale of corporate assets. In this respect, the courts have generally held that if the value or price determined by the directors falls within a range of values or prices in which reasonable people, fully informed, could differ in opinion, then the directors' business judg-

125. See, e.g., Spering's Appeal, 71 Pa. 11, 24 (1872). For a more recent example, see Everett v. Phillips, 288 N.Y. 227, 233-34, 43 N.E.2d 18, 20 (1942) (dictum). Notwithstanding such statements, however, the facts rarely support the extreme language used. Even in Spering's Appeal, it would appear that although the business judgment of the directors was indeed poor, as events turned out, they exercised some care by relying upon advice of counsel and their actions were not reckless or imprudent at the time.
126. The extreme of Spering's Appeal was laid to rest in Pennsylvania in 1933 by the enactment of a statutory standard of conduct. PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1979-1980). Even before then, the Pennsylvania courts showed a marked desire to avoid the rule's excess. See, e.g., Loan Soc'y v. Eavenson, 246 Pa. 407, 94 A. 121 (1915); Cornell v. Seddinger, 237 Pa. 389, 85 A. 446 (1912), cited in Rhoads, supra note 118, at 136-37. Earlier, Spering's Appeal had been rejected by the New York Court of Appeals in Hun v. Cary, 82 N.Y. 65 (1880). See also Adkins & Janis, supra note 118; Uhlman, supra note 83; Comment, Liability for Negligent Mismanagement, supra note 118.
ment will not be disturbed by the court. On the other hand, a court will interfere with the discretion vested in the board of directors upon a finding that the directors' judgment was arbitrary, resulted from a reckless disregard of the corporation's and its stockholders' best interests, or was simply so far removed from the realm of reason that it cannot be sustained.

One of the most significant cases in this area is *Gimbel v. Signal Companies, Inc.* In *Gimbel*, a stockholder of Signal Companies sought to enjoin the sale of a Signal subsidiary by Signal to Burmah Oil, Inc., a stranger to Signal. Plaintiff charged that the sale price of $480 million was too far below the property's fair value, $761 million. Significantly, the court commenced its inquiry by acknowledging the existence of a presumption that the board of directors acted in good faith in approving the sale, and that their judgment would not be disturbed if it could be attributed to a rational business purpose. But the court further emphasized that "[t]his does not mean, however, that the business judgment rule irrevocably shields the decisions of corporate directors from chal-

128. E.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("business judgment . . . will not be disturbed if [it] can be attributed to any rational business purpose"); Cottrell v. Pawcatuck Co., 36 Del. Ch. 169, 184, 128 A.2d 225, 233 (Sup. Ct. 1956) ("the directors acted within the reasonable limits of business judgment"); *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599, 615 (Del. Ch.) ("reasonable and reasoned decision"), aff'd, 316 A.2d 619 (Del. 1974); *Puma v. Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971) ("since the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uniformed opinion for that of the experienced, independent board members"); *Robinson v. Pittsburgh Oil Ref. Corp.*, 14 Del. Ch. 193, 203, 126 A. 46, 49 (Ch. 1924) ("whether or not the others would agree that the directors displayed sound judgment in rejecting the Hood offer to collect the notes and accounts for this reason, it nevertheless cannot be said that their action was so unreasonable as to be removed entirely from the realm of the exercise of honest and sound business judgment.").

129. E.g., Cottrell v. Pawcatuck Co., 36 Del. Ch. 169, 184, 128 A.2d 225, 233 (Sup. Ct. 1956) ("plaintiff has failed to show any such gross inadequacy of price as would justify an inference of reckless disregard of the rights of the minority stockholders"); *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599, 611 (Del. Ch.) ("The question is: did the Signal directors act recklessly in accepting a wholly inadequate price for Signal Oil?"); *aff'd*, 316 A.2d 619 (Del. 1974); *Muschel v. Western Union Corp.*, 310 A.2d 904, 908 (Del. Ch. 1973) ("a reckless indifference to the rights of others interested"); *Puma v. Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971) ("Nor can it be said that their action was in reckless disregard of the interests of the corporation or the rights of its stockholders for the testimony discloses sound business reasons for paying the obligation.").

131. *Id.* at 601.
132. *Id.* at 608-09.
lenge.” While acknowledging that the cases often used the word “fraud” in the business judgment rule context, the court made clear that “fraudulent misconduct” in this context could be “based simply on gross inadequacy of price.”

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

To further clarify the limits on the directors’ discretion, the court turned to earlier Delaware cases, in particular Allied Chemical & Dye Corp. v. Steel & Tube Co., where the court stated that “so long as the inadequacy of price may reasonably be referred to an honest exercise of sound judgment, it cannot be denominated as fraudulent.” That is an important point, and one frequently overlooked by detractors of the business judgment rule. It makes clear that “fraud” in the context of the business judgment rule does not refer only to invidious behavior, but also to an absence of reasoned judgment honestly exercised.

The court in Gimbel further analyzed the method by which the board of directors had authorized the transaction and determined that the board had discharged its duty to make a reasonable investigation into the value of the subsidiary and the terms of the transaction. But the court also found elements suggesting imprudence that called into question whether the directors had performed “their fiduciary obligation as directors to make an informed judgment of approving the transaction.” Of particular concern to the court was the speed with which the final transaction was presented to the board and with which the board acted. On balance, the court concluded that the plaintiff was unable to show a reasonable probability that he could pierce the business judgment

133. Id. at 609.
134. Id. at 610.
135. 14 Del. Ch. 1, 120 A. 486 (Ch. 1923).
136. Id. at 19, 120 A. at 494, quoted in Gimbel v. Signal Companies, Inc., 316 A.2d at 610.
137. 316 A. 2d at 615.
138. Id. at 614.
standard. However, that did not end the court’s inquiry; the court asked: “[D]id the Signal directors act without the bounds of reason and recklessly in approving the price offer of Burmah?” The court then considered the great disparity in price and concluded that fuller investigation at trial into the fair value was necessary. Therefore plaintiff was entitled to a preliminary injunction to maintain the status quo until after trial.

It is obvious from *Gimbel* that if the business judgment rule functioned to preclude any inquiry into a decision by a board of directors, the injunction would not have been issued. It was established to the court’s satisfaction that there were no vitiating personal interests and that it was improbable that plaintiff could impeach the exercise of business judgment, at least to the extent that plaintiff would be able to show that the directors had acted without due care. What led the court to interfere was not the absence of the exercise of business judgment, but a state of facts that, if proved, would demonstrate that the value of the property being sold so far exceeded the agreed sale price that the directors’ judgment constituted an abuse of discretion.

The situation in *Thomas v. Kempner* is even more striking. There, the refusal of the board of directors to consider a subsequent competing offer on the same terms but at a higher price led the court to enjoin the proposed sale of assets. Although the court linked the failure of business judgment to the unwillingness of the board of directors to use competitive bidding in the sale of the company’s assets, central to the court’s decision was the notion that when faced with two offers to purchase the company’s property that are identical in all respects except price, acceptance of the lesser of the two offers has no conceivable justification.

Because of the limitations placed on the directors’ discretion if they are to have the benefit of the business judgment rule, the rule does not preclude inquiry, but instead mandates inquiry into the facts and circumstances of a challenged transaction to such extent as may be necessary to enable the court to ascertain whether the director’s decision was an exercise of informed, reasoned judgment or an arbitrary or reckless decision. As the Third Circuit recently observed,

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139. *Id.* at 615.
140. *Id.* at 617-18.
[w]e do not think that the business judgment of the directors should be totally insulated from judicial review. In order for the directors’ judgment to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, where the shareholder contends that the directors’ judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors’ sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment.143

In conducting its own analysis of the reasonableness of the directors’ business judgment, the court does not attempt to decide whether it agrees with the directors’ judgment. The court determines only whether there is a reasonable basis for the directors’ decision.

Perhaps the clearest recent example of the purpose and scope of the judicial inquiry appears in Auerbach v. Bennett,144 a derivative suit against directors of General Telephone and Electronics Corporation to recover for improper payments abroad. Applying the business judgment rule, the New York trial court dismissed the suit because a special three-man committee of outside directors had decided not to sue.145 The appellate division reversed the trial court’s dismissal and remanded for a more complete investigation of the manner in which the special committee’s decision not to sue had been reached.146 Specifically, the court was concerned with the depth and amplitude of the investigation conducted by the committee and the emphasis it had placed on various factors such as the reasons for the payments, the advantages and disadvantages to the corporation, the extent of participation or profit by the individual defendants, and whether public confidence would be fostered by continuing the litigation.147 The appellate division also registered its concern that outside directors might well be hesitant to sue their fellow directors.148

The New York Court of Appeals disagreed with the appellate division and dismissed the suit.149 The court noted that the sub-

143. Id. at 275.
144. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), rev’g 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dep’t 1978).
145. 64 A.D.2d at 103, 408 N.Y.S.2d at 85.
146. Id. at 101, 108-09, 408 N.Y.S.2d at 84, 88-89.
147. Id. at 107, 408 N.Y.S.2d at 87-88.
148. Id.
149. 47 N.Y.2d at 636, 393 N.E.2d at 1004, 419 N.Y.S.2d at 930.
stantive decision of the committee, involving the weighing of legal, ethical, commercial, promotional, public relations, fiscal, and other concerns, fell squarely within the business judgment doctrine. Although refusing to inquire into which factors the committee considered or the relative weight accorded them, the court felt equipped to inquire into the methodologies and procedures best suited to the committee’s investigation. The committee had engaged special counsel to guide and advise it, had reviewed the prior work of the company’s audit committee, and had separately interviewed each director who had participated in the questioned payments. These procedures and methodologies were held neither insufficient nor infirm. Finally, the court noted that disqualification of the entire board would render the company powerless to make an effective business decision about the prosecution of a derivative action.

Lack of Good Faith

A director may also lose the benefit of the business judgment rule if plaintiff proves that the director’s challenged decision was prompted by improper motive, that the director was not truly independent from an interested party, or any other circumstance demonstrating a lack of good faith. There are no hard and fast rules in this area. Whether a particular circumstance other than self-dealing or other direct personal interest in the transaction makes the business judgment rule inapplicable depends upon the facts of each case.

Perhaps the most prevalent forms of bad faith or improper motive charged by plaintiffs are improper attempts by directors to preserve themselves in office and a lack of independence from controlling figures necessary to a good faith business judgment.

150. Id. at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928.
151. Id. at 634, 393 N.E.2d at 1002-03, 419 N.Y.S.2d at 929.
152. Id. at 635, 393 N.E.2d at 1003, 419 N.Y.S.2d at 929-30.
153. Id. at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. It should be noted that the court treated the committee’s judgment as if it were a decision by the whole board about the management of the company’s affairs.
Where a plaintiff can establish that the directors have authorized a transaction solely or primarily to preserve their control over the corporation, the business judgment defense is not available, even if the transaction could reasonably have been believed to be in the corporation's best interests at the time it was authorized. Conversely, if the effect of perpetuating control is merely incidental to a transaction authorized by the directors primarily with a view to the corporation's interests, the business judgment rule protects the authorizing directors. This distinction comports with the underlying purposes of the business judgment rule: A rule designed to protect directors in the honest exercise of their business judgment should not apply where such judgment is brought to bear only as an ex post facto justification for action taken primarily for personal reasons, such as to preserve oneself in office. The rule should, however, protect actions motivated by business considerations.

In recent years, shareholders have brought class and derivative actions against directors for their opposition to proposed tender offers for shares at prices substantially in excess of the current market prices, charging directors with bad faith and improper motives. This author is aware of only one such case that has been decided on its merits. Panter v. Marshall Field & Co., No. 78 C-537 (N.D. Ill. Mar. 3, 1980). See GM Sub Corp. v. Liggett Group, Inc., No. 6155 (Del. Ch. Apr. 25, 1980) ("not every action taken by a Board of Directors to thwart a tender offer is to be condemned"). See also Treadway Companies, Inc. v. Care Corp., [current] FED. SEC. L. REP. (CCH) ¶ 97,188 (S.D.N.Y. Nov. 29, 1979); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969).

After determining that a transaction was motivated solely or primarily by the personal concerns of directors to preserve their control over the corporation, the courts do not inquire into the transaction's desirability from the corporation's standpoint; the absence of business justification inevitably suggests the presence of improper motive. See, e.g., Bennett v. Propp, 41 Del. Ch. 14, 20, 187 A.2d 405, 408 (Sup. Ct. 1962); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975); Carr v. Interstate Cemetery Co., No. 3652, slip op. at 8 (Del. Ch. Feb. 1, 1972); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 363-65, 230 A.2d 769, 776-77 (Ch. 1967); In re Seminole Oil & Gas Corp., 38 Del. Ch. 246, 251-52, 150 A.2d 20, 24 (Ch. 1959). The absence of the business judgment defense need not yield a recovery of damages; a transaction undertaken by the directors solely or primarily for personal reasons may yield a corporate benefit, thereby precluding a finding of damage. See, e.g., Kors v. Carey, 39 Del. Ch. 47, 57, 158 A.2d 136, 142 (Ch. 1960); Yasik v. Wachtel, 25 Del. Ch. 247, 256-57, 17 A.2d 309, 313 (Ch. 1941).

even if such actions incidentally serve to perpetuate corporate control by their proponents.

Subservience to controlling figures similarly vitiates the business judgment rule. In Swenson v. Thibaut, stockholders sued derivatively former and present directors and officers for damages stemming from alleged mismanagement. In their defense, the defendant directors asserted that an independent litigation committee of nondefendant directors had determined that the corporation should not sue the defendant directors and such determination constituted a business judgment which precluded maintenance of the derivative action. The court rejected the defense, holding that the determination of the litigation committee was not in good faith for the following reasons: Many of the defendants were present board members; the three disinterested directors appointed as the litigation evaluation committee were not vested with plenary powers but were only an advisory group whose task was to report to the board; at the same meeting at which the committee was formed the full board voted to vigorously resist the plaintiff's derivative action; the company filed motions prior to the appointment of the committee to disqualify the plaintiff's attorneys; and there was no evidence in the record of any independent judgment exercised by the committee. Because the business judgment of the litigation committee not to prosecute the corporation's claims against the defendant directors and officers was held to have been influenced by the committee's relationship to the defendant directors, it was found not to be in good faith. Consequently the committee's determination did not cause the derivative action to be dismissed, as would have been the case if the court had applied the business judgment rule.

Bad faith may preclude the application of the business judgment defense where directors knowingly violate a statute or comparable expression of public policy, even if such a violation is

159. Id. at 82, 250 S.E.2d at 283.
160. Id. at 105, 250 S.E.2d at 297.
161. Id., 250 S.E.2d at 297-98.
162. Id. at 106, 250 S.E.2d at 298.
undertaken in the corporation's best interests.\textsuperscript{164} The defense may prevail where directors' actions motivated by the corporate welfare are not clearly contrary to law when taken.\textsuperscript{165} Where illegality is clear, however, the courts will not give such conduct by directors the benefit of a presumption against liability. Such benefit would contravene the spirit of statutes governing indemnification of directors, which explicitly preclude indemnification for any criminal action unless the director "had no reasonable cause to believe that his conduct was unlawful."\textsuperscript{166}

Thus, in the absence of the business judgment defense, directors are liable to the corporation for losses sustained by the corporation because of knowingly illegal conduct. It is a closer question, and one on which the courts appear divided, as to whether directors may claim a setoff against such liability by establishing that the corporation received benefits from the illegal conduct in question.\textsuperscript{167}

The Business Judgment Presumption

The business judgment rule is sometimes expressed as a factual presumption\textsuperscript{168} in favor of directors: The court will presume, until shown otherwise, that the directors have in fact exercised, in good faith, their best business judgment in what they believed to be the corporation's best interests.\textsuperscript{169} The presumption, if indeed it is a true presumption, appears in reality to do little more than to emphasize that the burden of proof or risk of nonpersuasion rests

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\textsuperscript{166} DEL. CODE ANN. tit. 8, § 145(a) (Supp. 1974). See, e.g., N.Y. BUS. CORP. LAW § 723(a) (McKinney Supp. 1979); ABA-ALI MODEL BUS. CORP. ACT § 5(a) (rev. ed. 1974).


\textsuperscript{168} A factual presumption is simply a fact presumed to be true once some other basic fact is found to exist. 9 J. WIGMORE, EVIDENCE § 2490 (3d ed. 1940).


http://scholarlycommons.law.hofstra.edu/hlr/vol8/iss1/6
with the plaintiff who attacks a directorial decision. Further, it tells the plaintiff what he or she must prove to enjoin a transaction or to impose personal liability on individual defendants.  

The basic fact necessary to trigger the business judgment rule's presumption will generally be established by the plaintiff who seeks to challenge a directorial decision. By showing that an individual defendant made some decision as a director—a necessary prerequisite to a director's liability—the plaintiff establishes the basic fact from which the presumption is drawn. Thus, the effect of the presumption is to raise the business judgment rule as a defense at the outset and require the plaintiff to establish one or more of the conditions that will negate the defense. The hard question is the degree or quality of proof necessary to negate the presumption. Although some cases speak in terms of the need to present strong evidence or evidence that will "convincingly prove," other cases speak only in terms of "in the absence of evidence to the contrary." Such general statements, however, are meaningless outside the context in which they are made. Generally, where the plaintiff attacks the availability of the business judgment rule because of self-dealing or personal interest, the presumption is overcome when the plaintiff introduces credible evidence upon which to base a conclusion adverse to that of the individual defendants.

The relative strength of the presumption is indicated in Marks v. Wolfson. There, stockholders challenged a sale of corporate assets that gave the majority stockholder of the parent corporation a tax advantage denied to public stockholders of the subsidiary corporation. At the conclusion of plaintiffs' case, the defendants moved under Delaware Chancery Court Rule 41(b) for a dis-

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170. Generally, the existence of the presumed fact continues until evidence has been introduced that would justify a finding of nonexistence of the presumed fact, at which point the presumption disappears. J. Wigmore, *supra* note 168, § 2490.


174. *Id.*

175. *Id.* at 117-23, 188 A.2d at 681-85.

176. *Del. Ch. Ct. Rule* 41(b), which is in substance identical to *Fed. R. Civ. P.* 41(b), provides in relevant part: "After the plaintiff has completed the presentation of his evidence, the defendant, without waiving his right to offer evidence in the event the motion is not granted, may move for a dismissal on the ground that upon the facts and the law the plaintiff has shown no right to relief."
missal without prejudice to their right to offer further evidence in
the event that their motion was not granted. In granting dismissal,
the court indicated that it was insufficient for the plaintiffs to have
introduced some evidence in support of their contentions; rather,
in the court's opinion, the plaintiffs were required to prove their
case. Since it is generally recognized that a plaintiff need prove
his or her case only by a preponderance of the evidence, and not
by some greater standard, the presumption in favor of proper di-
rectorial action will not be overcome until the plaintiff introduces
sufficient evidence to permit the trier of fact to find that personal
interest or some other vitiating factor is established by a prepon-
derence of the evidence. It appears that the same standard of a
preponderance of the evidence applies where the plaintiff attempts
to deprive the directors of the business judgment rule defense be-
cause the directors failed to exercise the requisite degree of care or
because their decision was in some fashion not in good faith.

Plaintiffs have the heaviest burden of proof when, being un-
able to establish self-dealing, other personal interest, lack of due
care, bad faith, or improper motive, they are reduced to attacking
the decision or judgment of the board of directors on the basis of
abuse of discretion—conduct sometimes characterized by the
courts as "constructive fraud." Historically, to prove fraud or
constructive fraud in civil actions, one must do so by clear and con-
vincing evidence, rather than by a mere preponderance of evi-

177. In the words of the court:
In conclusion, I am unable to accept plaintiffs' contentions that the burden
has now been shifted to the moving defendants and that Rule 41(b) motions
may not be granted because of the fact that plaintiffs have either introduced
some evidence in support of their contentions or that because of New York
Shipbuilding's fiduciary position as a majority stockholder of Highway
Trailer, its decision to sell caused it to reap a special and unfair benefit. To
apply Rule 41(b) as plaintiffs would have the court do, would, in my opin-
ion, emasculate its obvious purpose in cases of this sort. I say this because
of the presumption in favor of proper directorial action, and the fact that
even where corporate action has been allegedly taken to benefit majority
stockholders the burden of proving bad faith and the like rests on the plain-
tiff. In other words, plaintiffs, notwithstanding the fiduciary relationships
relied upon, were required to prove their cases.
41 Del. Ch. at 126-27, 188 A.2d at 687 (citation omitted).
178. See generally W. Fletcher, supra note 12, § 1340.
179. For example, the directors may be dominated by, or lack independence from,
controlling directors or stockholders. See cases note 155 supra.
180. See, e.g., Gimbel v. Signal Companies, Inc., 316 A.2d 599, 610 (Del. Ch.),
aff'd, 316 A.2d 619 (Del. 1974); Marks v. Wolfson, 41 Del. Ch. 115, 123, 188 A.2d
680, 685 (Ch. 1963); Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1,
12, 120 A. 486, 491 (Ch. 1923).
This rule of quality and quantum of evidence plays a role in making the plaintiff's burden heavy in establishing that a decision of the board of directors is so lacking in reason that it cannot be the product of a good faith or honest decision. The problem is exacerbated because in the realm of business decisions, particularly those that turn on the value of corporate assets or stock, there is room for legitimate disagreement. Thus, in such cases, it is generally the plaintiff's burden to prove that the challenged decision by the directors was so out of line that it can only be attributed to improper motives, reckless indifference,\footnote{See, e.g., Marks v. Wolfson, 41 Del. Ch. 115, 126, 188 A.2d 680, 687 (Ch. 1963). See generally W. Fletcher, supra note 12, § 1340.} or a deliberate disregard of the corporation's interests.

Although from an historical perspective, a clear and convincing evidence standard may be appropriate in abuse of discretion cases, such a standard is not in fact generally applied. Rather, if a plaintiff can demonstrate by a preponderance of the evidence that reasonable people could not differ with respect to the inadequacy of the price or the unconscionable effects of the transaction, then the transaction will be enjoined or, if consummated and not rescindable, the directors will be held liable.\footnote{Quaere: Is there necessarily a difference in this context between conduct that is characterized by "indifference" and that which is characterized by "reckless indifference"? Isn't any "indifference" by a director to the interests of the corporation or its stockholders "reckless"?} What may appear at times as a clear and convincing standard of proof requirement in reality reflects only the inherent difficulty in proving by a preponderance of the evidence that a given decision is so unsupportable that it cannot have been the product of a good faith exercise of business judgment.

Finally, it should be reiterated that the presumption in favor of the exercise of good faith business judgment by defendant directors is rebuttable. A plaintiff is never deprived by the business judgment rule of an opportunity to prove his or her case.

CONCLUSION

It has been the central thesis of this Article that both the critics and the more ardent supporters of the business judgment rule read too much into the language that the courts have used in recognizing that the acts of a board of directors are clothed with a variety of favorable, albeit rebuttable, presumptions. This author's understanding of the rule may fly in the teeth of some words and
phrases in a number of cases. It is true that over the years the opinions of courts have contained such statements as "[a] board of directors enjoys a presumption of sound business judgment," and "[t]he acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation." Because of such a presumption, courts have also said that to establish a breach of the director's duty a plaintiff is required to show "fraud," "palpable overreaching," "reckless indifference," or "deliberate disregard of the interests of the whole body of stockholders." However, a careful reading of these opinions suggests that the term "business judgment rule" and the presumption that often identifies it mean simply that a stockholder who challenges a nonself-dealing transaction must persuade the court that the corporation's directors, officers, or controlling stockholders in authorizing the transaction did not act in good faith, did not act in a manner they reasonably believed to be in the corporation's best interest, or did not exercise the care an ordinarily prudent person in a like position would use under similar circumstances.

If a stockholder can prove any one of the three items of misconduct or malfeasance enumerated in the statement of the rule offered earlier, there is little doubt that a court would enjoin the transaction if not consummated, or if consummated, would either rescind it or render judgment against the directors for the corporation's consequent damages. It is a questionable proposition indeed that a court would determine that the business judgment rule precludes such action.

If this understanding of the business judgment rule is correct, then it is not substantively different from the standard articulated nearly 150 years ago or from section 35 of the Model Business Corporation Act, which has come to be generally accepted as the proper standard by which to measure a director's performance of his or her duties. Those who argue that the business judgment rule condones conduct less exacting than that demanded by section 35 of the Model Business Corporation Act misread case law.

188. Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 325, 147 A. 257, 261 (Ch. 1929).
189. Id.
190. See text accompanying note 85 supra.
191. See text accompanying note 10 supra.