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The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?

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As one might suspect from the title, this Article attacks the business judgment rule. In fact, it advocates the rule's abolition. Admittedly, this is not a minor task given that the rule, in one form or another, extends back through 160 years of judicial decisions. Indeed, just recently, the American Law Institute enshrined a version of the rule in its *Principles of Corporate Governance.*

At first glance, the general concept behind the rule seems unassailable. Courts generally should exercise caution in second guessing corporate directors' decisions, at least when the directors do not face any conflict of interest when they make decisions. However, a problem occurs when courts and writers attempt to inject specific content into this general proposition—immediately, a lack of consensus

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1. One of the earliest cases expressing the idea that directors should not be liable for errors in judgment is Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829). See also Godbold v. Branch Bank, 11 Ala. 191 (1847) (holding that bank directors are not responsible for judgment errors unless so grossly wrong as to show fraud or lack of knowledge); Hodges v. New England Screw Co., 1 R.I. 312 (1850) (holding that directors exercising ordinary care and prudence are not responsible for mistaken charter violations).


A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:

(1) is not interested . . . in the subject of business judgment;

(2) is informed with respect to the subject of business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.
emerges as to what the rule really is. Part I of this Article explores its various interpretations.

Part I shows that interpretations of the business judgment rule fall into two broad categories. In the first category, the rule essentially stands for the proposition that directors are not liable for their decisions unless there is a reason to hold the directors liable—such as when the directors have breached their duty of care. A corollary to this interpretation of the "rule" is that the mere existence of a bad outcome from a business decision, or the fact that some individuals might disagree with the decision’s wisdom, does not mean the decision was negligent. Needless to say, if this was the only interpretation of the business judgment rule, then any further discussion of the "rule"—not to mention the "rule" itself—would be largely pointless.

The practical significance of the business judgment rule comes from the second category of interpretations. Here, many courts, writers, and now the American Law Institute, view the rule as imposing a substantive qualification upon directors' liability for breach of the duty of care. Specifically, under these interpretations, directors must be guilty of a greater degree of fault than ordinary negligence in order to face liability. The precise degree of fault varies substantially depending upon the court or writer. However, all of this category's proponents agree that the standards of ordinary negligence sufficient to create liability for automobile drivers, doctors, lawyers, and just about anyone else except children are not sufficient in an action on behalf of the corporation against its directors.

Part II of this Article examines this proposition. Why do directors occupy a privileged caste vis-à-vis other private individuals who are sued for negligence? Adherents to certain schools of thought might explain this distinction as simply another example of the law favoring those with greater wealth and power. It is not the purpose of this Article, however, to engage in such speculation. Instead, Part II assesses the viability of the articulated rationales behind the special treatment. Many argue that policy concerns about deterring business

4. See infra text accompanying notes 25-35.
5. See infra part II.B.
6. In contrast to directors, even doctors and attorneys, who are subject to a more stringent standard in malpractice cases, are for the most part only members of the upper-middle class.
risk-taking justify a more lenient standard when subjecting board decisions to after-the-fact review. Others point to the nature of the damages caused by director mistakes or to facts which make the typical plaintiff shareholder less than a sympathetic victim. Adherents to law-and-economics methodology assert that director liability for negligence serves little utility. Part II shows these rationales largely fall victim to the same flaw: They fail to justify a differentiation between directors and other prospective tort defendants who can and do assert similar arguments for more lenient treatment.

In the end, the business judgment rule turns out to be either meaningless (the first category of interpretation) or misguided (the second category). This Article therefore concludes that the rule should be abolished and directors be required to live with the same rules of negligence as everyone else.

I. WHAT IS THE BUSINESS JUDGMENT RULE?

Defining the business judgment rule is no easy task; just ask the drafters of the most recent revision of the Model Business Corporation Act. They initially thought it would be a good idea to include the rule as part of the Act. This made sense because the Act sets out a standard for directors’ duty of care which is closely related to the rule. This process broke down, however, when the drafters could not reach a consensus on a formulation of the rule. As one of the participants explained, “[W]e are saying that there is a business judgment

7. See infra text accompanying notes 77-91.
8. See infra text accompanying notes 115-18.
9. See infra text accompanying notes 126-29.
10. See infra text accompanying notes 142-55.
12. In the end, the Model Act simply punts by including the following apologia in the Official Comment to section 8.30: The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts, in view of that continuing judicial development, section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this section. That is a task left to the courts and possibly to later revisions of this Model Act.

M.B.C.A. § 8.30 Official Cmt.
rule, that we know what it is and when it should be applied, but we can't define it.” 13

Much of the difficulty with efforts to define the business judgment rule, such as that involved with the Model Act, stems from a faulty starting premise. This premise is that there is a business judgment rule. In fact, there is no single rule. Instead, the phrase “the business judgment rule” has a number of different meanings. To aid analysis, it is useful to group these meanings into two categories.

A. THE BUSINESS JUDGMENT RULE AS A TAUTOLOGICAL STATEMENT

A widely used hornbook on corporate law 14 provides a good illustration of the first common usage of the phrase “the business judgment rule.” In black letter, the book’s authors state, “The ‘business judgment’ rule sustains corporate transactions and immunizes management from liability where the transaction is within the powers of the corporation (intra vires) and the authority of management, and involves the exercise of due care and compliance with applicable fiduciary duties.” 15 Numerous court decisions contain similar descriptions of the so-called rule. 16 For example, in Miller v. American Telephone & Telegraph Co., 17 the court explained:

The sound business judgment rule . . . expresses the unanimous decision of American courts to eschew intervention in corporate decision-making if the judgment of directors and officers is uninfluenced by personal considerations and is exercised in good faith. . . . Underlying the rule is the assumption that reasonable diligence has been used in reaching the decision which the rule is invoked to justify. 18

A moment’s reflection establishes that these statements really do not say much of anything. Stating that directors will be immune from

15. Id. at 661; see also ROBERT C. CLARK, CORPORATE LAW 123-25 (1985).
17. 507 F.2d 759 (3d Cir. 1974).
18. Id. at 762.
liability so long as they act with due care (or reasonable diligence) and comply with their fiduciary duties (that is, are disinterested and act in good faith) is simply saying that directors will not be liable for their decisions unless there is a reason for holding them liable. Specifically, directors will only be held liable if they breach their duties of care or loyalty. This is hardly an earth-shattering proposition. Similarly, the expression that the rule "sustains transactions"—in other words, the court will not deny effectiveness to decisions of the board of directors—so long as there is authority, due care, and no breach of fiduciary duty, is simply another way of saying that the board has the statutory power to manage the corporation and the court will not interfere without some grounds. 19

As might be expected, there are a number of variations on this use of the phrase. For example, some sources point out that the rule only applies to business judgments—in other words, the challenge must involve a decision the directors made rather than an instance in which the directors were merely inattentive. 20 Other sources add assorted items such as the absence of fraud 21 or illegality, 22 to the prerequisites for the rule’s protection. These additions may be marginally useful for those desiring a handy checklist of ways in which directors can breach their duties of care or loyalty, but there still is not much real significance to this "rule." Another common variation on this theme is to state the "rule" as containing a rebuttable presumption. 23 The presumption is that the directors did not violate their duties—in other words, did not put themselves in a conflict of interest, act in bad faith or without due care, or the like—when they made

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19. At least one writer has attempted to introduce a different label (the "business judgment doctrine") for the question of whether a court will deny effect to a decision by the board, as opposed to holding the directors personally liable for damages. Joseph Hinse v IV, *Business Judgment and the American Law Institute’s Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 Geo. Wash. L. Rev. 609, 611-13 (1984). Beyond semantics, the significance lies in the possibility that courts might apply a different standard in addressing the issue of whether to deny effect versus the question of whether to award damages.


23. *E.g.*, Hanson Trust Plc. v. ML SCM Acquisition Inc., 781 F.2d 264, 273 (2d Cir. 1986); Treadway Cos., 638 F.2d at 382; Warshaw v. Calhoun, 221 A.2d 487, 493 (Del. 1966).
their decision.\textsuperscript{24} Here, too, there is less substance than meets the eye. This "presumption" entails nothing more than saying that the plaintiff who challenges a decision of the board has the burden of proving that the directors breached one of their duties. Yet, the proposition that the plaintiff, in any context, has the burden of proving his or her prima facie case is a rule with which every first-year law student should be familiar.

Given the not-surprising conclusion that directors are only liable if the plaintiff proves that the directors breached their duties, the question then becomes whether the business judgment rule says anything significant about what it takes to prove a breach, particularly of the duty of care. For many courts and writers the answer is really no. These courts and writers apply concepts of ordinary negligence to identify conduct that breaches the directors' duty of care.\textsuperscript{25} For example, in one of the most often quoted reconciliations of the business judgment rule with the law of negligence, a New York trial court explained:

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.\textsuperscript{26}

Probably the most widely cited case actually applying an ordinary negligence standard to find directors liable for a business decision is

\textsuperscript{24} The business judgment rule is . . . a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company . . . . The burden is on the party challenging the decision to establish facts rebutting the presumption.

\textit{Aronson,} 473 A.2d at 812.


\textsuperscript{26} \textit{Casey,} 49 N.Y.S.2d at 643.
Litwin v. Allen. In Litwin, a New York trial court held the directors of Guaranty Trust Company liable for their decision to purchase three million dollars of debentures. The problem, as the court saw it, was that the purchase agreement gave the seller the option to repurchase the debentures at the sale price within six months. This put the risk of loss if the debentures declined in value—as they in fact did—on Guaranty Trust. At the same time, Guaranty Trust did not obtain the corresponding potential for gain, because, if the debentures appreciated, the seller presumably could exercise its option to repurchase. The court concluded:

There is more here than a question of business judgment as to which men might well differ. The directors plainly failed in this instance to bestow the care which the situation demanded. Unless we are to do away entirely with the doctrine that directors of a bank are liable for negligence in administering its affairs liability should be imposed in connection with this transaction.

The court further explained its view of the business judgment rule when it stated, “[D]irectors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence . . . .”

This version of the business judgment rule continues the type of broad tautological statement quoted earlier to an unexceptional conclusion: Directors are not liable unless they breach their duties of loyalty or care, and the duty of care is that of reasonable skill and prudence—the same standard as is the norm throughout the law of torts. About the only thing the “rule” adds is a cautionary note that an error in judgment or a mistake—in the sense of a decision that does not turn out as one hoped—does not automatically equal negligence. This same caution could be sounded for doctors, lawyers, or automobile drivers sued for their mistakes.

27. 25 N.Y.S.2d 667 (Sup. Ct. 1940).
28. Id. at 699.
29. Id. at 678.
30. See, e.g., Restatement (Second) of Torts § 283 cmt. c (1965) (equating “reasonable man” and “ordinary prudence”); Restatement (Second) of Agency § 379(1) (1984).
31. The fundamental concept of negligence does not vary, whether it is applied to the case of a simple personal injury action or to liability of directors in the management of the affairs of their corporation. A pedestrian crossing the street is under a duty to use reasonable care. He is required to look before he crosses, but “the law does not say how often he must look or precisely how far, or when or from where . . . . If he has used his eyes, and has miscalculated the danger, he may still be free from fault.” The law does not hold him guilty of negligence although if he had looked oftener the accident might have been avoided. He discharges his duty when he has acted with reasonable
In fact, while no one speaks of a "medical," "legal," or "vehicle operator judgment rule," there is a similar cautionary "rule" sometimes invoked especially in the medical-malpractice field. This is the "honest error in judgment rule." The Minnesota Supreme Court in *Ouellette v. Subak* quoted a typical expression of this rule: "A [physician] is not a guarantor of a cure or a good result from his treatment and he is not responsible for an honest error in judgment in choosing between accepted methods of treatment." The parallel between this language and the language in *Litwin* and in numerous similar invocations of the business judgment rule is evident.

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33. 391 N.W.2d 810 (Minn. 1986).

34. Id. at 813. The court in *Ouellette* went on to reformulate the "rule" out of concern that the phrase an "honest error in judgment" in the quoted jury instruction could mislead the fact finder into putting too much emphasis on the defendant's subjective good intentions. The court restated the rule:

> A doctor is not negligent simply because his or her efforts prove unsuccessful. The fact a doctor may have chosen a method of treatment that later proves to be unsuccessful is not negligence if the treatment chosen was an accepted treatment on the basis of the information available to the doctor at the time a choice had to be made; a doctor must, however, use reasonable care to obtain the information needed to exercise his or her professional judgment, and an unsuccessful method of treatment chosen because of a failure to use such reasonable care would be negligence.

*Id.* at 816. The relevance for the business-judgment-rule context of the court's concern with subjective phraseology will be addressed later. The "unavoidable accident rule" plays a somewhat similar role in many tort cases, reminding the fact finder that the mere existence of an injury does not mean there was negligence. E.g., Butigan v. Yellow Cab Co., 320 P.2d 500, 508 (Cal. 1958) (Schauer, J., dissenting).

35. See, e.g., Nanito v. Teksee Hybrid Co., 341 F. Supp. 240, 244 (D. Neb. 1972), aff'd, 473 F.2d 537 (8th Cir. 1973) ("Directors and officers of a corporation may become liable to it or the shareholders for negligence in the performance of their corporate duties. However, they are not insurers and are not generally held liable for errors of judgment or mistakes while acting with reasonable skill and prudence."); Bailey v. Babcock, 241 F. 501, 515 (W.D. Pa. 1915) ("But for an honest error of judgment the law has no punishment."); *Casey*, 49 N.Y.S.2d at 642 ("Mistakes in the exercise of honest business judgment do not subject the directors to liability for negligence without more.")
B. THE BUSINESS JUDGMENT RULE AS A SPECIAL STANDARD OF LIABILITY FOR DUTY OF CARE VIOLATIONS

An alternate interpretation of the business judgment rule is far more significant. Numerous courts and writers—now joined by the American Law Institute—view the business judgment rule as providing a special standard of culpability against which to assess whether directors breached their duty of care.36 Unfortunately, these courts and commentators disagree on what the standard is or should be. Worse still, several factors complicate any effort to delineate the respective views. For one thing, judicial opinions in this area are replete with imprecise and inconsistent use of language.37 As a result, some opinions sound as if they are employing different standards, when, in fact, the courts really mean the same thing.38 Alternately, some formulations may sound the same, but, in fact, embody quite different standards.39 In addition, the different standards in this area range along a continuum, rather than representing discrete splits of authority.40 Nevertheless, it is possible to discern three major viewpoints which go far to define this spectrum. The viewpoints’ common bond is that each holds that director liability under the business judgment rule requires greater fault than ordinary negligence.

36. More precisely, the rule represents the standard when the alleged breach of the duty of care involves a decision made by directors—including a decision to refrain from acting—as opposed to complete inattention to their jobs. See supra note 20 and accompanying text.

37. E.g., Meyers v. Moody, 693 F.2d 1196, 1209-11 (5th Cir. 1982) (referring interchangeably to negligence and gross negligence); Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 711-12 (N.D. Ill. 1969) (referring to the standard as “that care which businessmen of ordinary prudence use in managing their own affairs,” but stating that the court will not set aside the board’s action absent “proof of fraud or manifestly oppressive conduct”); see also Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1150-51 (5th Cir. 1989) (discussing Louisiana case law); Gearhart Indus. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984) (noting inconsistencies in Texas case law); Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984) (noting inconsistencies in terminology used by prior Delaware court opinions); Selheimer v. Manganese Corp., 224 A.2d 634, 642 (Pa. 1966) (discussing prior Pennsylvania case law); Richard B. Dyson, The Director’s Liability for Negligence, 40 Ind. L.J. 341, 367-76 (1964) (exploring the different standards of care and confusing language used by various jurisdictions).

38. See, e.g., Aronson, 473 A.2d at 812 n.6 (listing different terms used by Delaware cases to embody a gross negligence standard).

39. Compare Aronson, 473 A.2d at 812 (using gross negligence to refer to a less exacting standard of care than simple negligence) with Wallace v. Lincoln Sav. Bank, 15 S.W. 448, 454 (Tenn. 1891) (referring to gross negligence as the failure to exercise ordinary care).

40. See infra notes 48, 63, and text accompanying note 69.
1. The Good Faith Standard

At the opposite extreme from ordinary negligence are the courts and writers who view the business judgment rule as commanding a largely subjective approach. The New York trial court’s opinion in Kamin v. American Express Company provides a good example of this position. Kamin involved a shareholders’ derivative complaint against directors of American Express Company who approved distributing an in-kind dividend. This dividend consisted of shares of stock which American Express had purchased some years before as an investment and which had declined substantially in value. The plaintiffs contended the directors should have sold the shares at a loss, not distributed them to the stockholders. In this manner, the corporation could have obtained a capital-loss deduction, which would have saved it significant taxes. The court dismissed the complaint as not stating a cause of action. In doing so, the court set out a standard of liability which, from all appearances, disclaims any objective review of directors’ decisions:

Section 720(a)(1)(A) of the Business Corporation Law permits an action against directors for “the neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge.” This does not mean that a director is chargeable with ordinary negligence for having made

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43. The reader, recalling the earlier discussion of Litwin, see supra notes 27-29, may wonder how New York court opinions could provide such extremely different views of the business judgment rule. This illustrates that attempting to use the business judgment rule as a standard for breach of duty of care liability has produced as much or more intrajurisdictional confusion as it has interjurisdictional divisions of authority. See also Gearhart Indus., 741 F.2d at 721 (discussing inconsistencies in Texas court interpretations of the business judgment rule).

44. From a tax-planning standpoint the board’s decision made no sense. The shareholders received a basis equal to no more than the current fair market value of the distributed stock. I.R.C. § 301(d) (1975). Hence, the potential for a loss deduction was destroyed for everyone. Nor, apparently, was the dividend tax-free to the recipient shareholders, as there is no indication that American Express owned enough shares for a tax-free spinoff under I.R.C. § 355. The board’s rationale for the in-kind dividend evidently was to avoid recognizing a loss that might depress the price of American Express stock. Kamin, 383 N.Y.S.2d at 811. How legitimate should be the goal of attempting to bamboozle the market (or avoid embarrassing the directors) in this manner seems questionable. Accordingly, the directors’ decision seems no more reasonable than the action condemned in Litwin.
an improper decision, or having acted imprudently. The “neglect” referred to in the statute is neglect of duties (i.e., malfeasance or nonfeasance) and not misjudgment. To allege that a director “negligently permitted the declaration and payment” of a dividend without alleging fraud, dishonesty or nonfeasance, is to state merely that a decision was taken with which one disagrees.45

Under this approach, a court’s review of a challenged decision focuses largely, if not exclusively, upon the subjective motivations for the action. While courts use a variety of terms to identify the pertinent inquiry—such as the presence or absence of good faith, honesty, or fraud46—the heart of the matter is whether or not the directors believed that what they were doing was in the best interest of the corporation.47 Excluded from the courts’ inquiry for the most part is any review of the objective reasonableness of such a belief.48 Under the most extreme interpretation, the business judgment rule effectively abolishes the duty of care for any situation in which the plaintiff challenges an action by the board. Instead, all that remains of the duty under this view is to avoid the sort of inattention and inactivity typified by cases such as Francis v. United Jersey Bank,49 in which the

47. See, e.g., Stern, 924 F.2d at 478 n.8 (2d Cir. 1991) (equating bad faith with an improper purpose); Washington Bancorporation v. Said, 812 F. Supp. 1256 (D.D.C. 1993); Levitan v. Stout, 97 F. Supp. 105, 117 (W.D. Ky. 1951) (defining actual fraud as causing intentional injury to the corporation for the director’s own benefit and constructive fraud as acts done with no purpose to harm the corporation but which the directors performed in a conflict of interest); Bodell v. General Gas & Elec. Corp., 140 A. 264, 267 (Del. Ch. 1927).
48. As stated earlier, views of the business judgment rule as a standard for duty of care liability form a continuum rather than precisely defined positions. See supra text accompanying note 40. Few unequivocally rule out any review of objective reasonableness. Instead, after proclaiming that directors’ decisions are unassailable in the absence of bad faith, dishonesty, or fraud, such opinions often soften such statements by backpaddling in varying degrees. Some opinions, like Kamin, supplement holding claims limited to fraud or bad faith with a finding that the directors’ decision was objectively reasonable (or, at least, finding the plaintiff had not shown the decision was unreasonable). 363 N.Y.S.2d at 811; see also Shlensky v. Wrigley, 237 N.E.2d 776, 780-81 (Ill. App. Ct. 1968) (stating that baseball team director’s failure to mirror practices of other team directors was not negligent). Other opinions adhering to a largely subjective approach expressly leave the door open to finding liability in a truly egregious case despite good motives. E.g., Fielding v. Allen, 99 F. Supp. 137, 142 (S.D.N.Y. 1951); Spering’s Appeal, 71 Pa. 11, 20-21 (1872).
director ignored all corporate affairs while her sons looted the company.50

2. The Gross Negligence Standard

One middle ground between ordinary negligence and the “good faith only” standard is found in Delaware. The Delaware Supreme Court has settled, at least since the mid-1980s, on the notion that the business judgment rule embodies a standard of gross negligence. Delaware’s Supreme Court announced this position in Aronson v. Lewis by stating that “[w]hile the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.”51 The Delaware Supreme Court subsequently reaffirmed this standard in Smith v. Van Gorkom.52 These holdings remove what had been a lingering uncertainty about whether earlier Delaware court opinions that used language suggesting a gross negligence standard53 really meant what they implied.54 While Delaware thus provides the clearest and most important expression of this approach, the gross negligence standard extends well beyond the Delaware courts.55

50. See also Gamble v. Brown, 29 F.2d 366 (4th Cir. 1928) (finding that bank directors were so uninvolved that bank officer had little trouble embezzling funds), cert. denied, 279 U.S. 839 (1929); Heit v. Bixby, 276 F. Supp. 217 (E.D. Mo. 1967) (finding directors negligent for allowing condition to exist in which codirectors were able to earn unlawful commissions).


52. 488 A.2d 858, 873 (Del. 1985).


54. See Arsh, supra note 25. Despite this apparent clarification, there remains some confusion in Delaware Chancery Court opinions as to whether the gross negligence standard applies only to issues regarding the process used by the directors to reach a decision, as opposed to the decision itself. Compare Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986) (applying a gross negligence test to both process and substance of decision) with In re J.P. Stevens & Co., 542 A.2d 770, 780-81 (Del. Ch. 1988) (suggesting a weaker standard of review when dealing with substance of decision than with process used to reach it). Because a number of the opinions cited by Aronson in adopting the gross negligence standard involved review of the substance of directors’ actions, it is difficult to see the basis for arguing that the gross negligence standard in Delaware applies only to review of the process used by directors.

This leaves two related questions: First, what exactly does the gross negligence standard mean, and second, how is this standard different from ordinary negligence? One Delaware court has said that “in the corporate area, gross negligence would appear to mean, ‘reckless indifference to or a deliberate disregard of the stockholders’ . . . or actions which are ‘without the bounds of reason.’”56 The reader may be forgiven for finding such a definition less than entirely helpful. In fact, it is difficult to pin a precise meaning upon the term gross negligence.57 This has led some to suggest that the term has no significance58 or, put another way, gross negligence is the same thing as negligence “with the addition of a vituperative epithet.”59 Reinforcing this skepticism is the fact that it is not easy to find cases applying the gross negligence standard to directors’ actions in which use of this standard, rather than an ordinary negligence test, unquestionably made a critical difference to the outcome.60

A good example is the Delaware Supreme Court’s decision in Smith v. Van Gorkom.61 The court found the directors of Trans Union Corporation liable for deciding to sell the company after only a two-hour meeting, at which they relied upon a twenty-minute oral presentation concerning the transaction and did not read the merger agreement or inquire into the basis for the agreed price. While the majority of the court found this to be gross negligence, a pointed dissent, since joined by other critics,62 raised questions which lead one to wonder whether there was even ordinary negligence here. Those disagreeing with the majority’s conclusion point to the fact that the directors were highly sophisticated in business and thoroughly familiar with the company. Hence, it is doubtful if the directors really needed additional time or advice to assess whether the offered price was a good one, especially when it represented a substantial premium over market and when the stockholders could still vote the deal down. In any event, regardless of who is right or wrong as to the result in Van Gorkom,

56. Rabkin, 547 A.2d at 970 (citation omitted).
60. See, e.g., Veasey & Manning, supra note 11, at 928; Dyson, supra note 37, at 373 n.136.
61. 488 A.2d 858 (Del. 1985).
this dispute makes it evident that the gross rather than ordinary negligence label had little impact upon the result.

Still, one should not dismiss the term gross negligence too quickly. Even if not amenable to precise definition, most individuals would have no trouble understanding that gross negligence entails some worse level of dereliction than ordinary negligence. In fact, recent litigation concerning the liability of directors of failed financial institutions suggests there may be more significance to the gross negligence label than some critics thought. Otherwise, one would be hard pressed to explain the plethora of reported decisions involving the question of whether the FDIC may assert state law claims sounding in ordinary negligence against directors of failed banks, or whether federal legislation limits such claims to gross negligence.

3. The Process-Versus-Substance Distinction

The American Law Institute’s Principles of Corporate Governance provides an example of another approach to duty of care liability under the business judgment rule. This approach draws a distinction between the level of judicial scrutiny of the directors’ decision itself, and review of the process the directors used to arrive at the

63. *E.g., Keeton et al., supra note 57, at 211-32.* In fact, the idea behind a number of opinions employing a gross negligence test is simply that the standard for director liability should require more than the ordinary negligence commonly creating tort liability, but not as much as a test that focuses solely on subjective motivations. *See, e.g., Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1150 (5th Cir. 1989) (“the standard . . . lies somewhere between simple negligence and willful misconduct or fraud with intent to deceive”); Aronson v. Lewis, 473 A.2d 805, 812 n.6 (1984) (“director liability is predicated on a standard which is less exacting than simple negligence”). *But see Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 971 (Del Ch. 1986). This again illustrates the continuum nature of the various views of the business judgment rule as a standard for breach of duty of care liability.

From a practical standpoint, the significance of a gross negligence test may be more a matter of altering statistical probabilities than of changing the results in any specific case. If enough fact finders in enough close cases are instructed they may find the defendants liable only if they find gross rather than ordinary negligence, there will be in all likelihood a greater number of defense verdicts.

decision. Specifically, for the business judgment rule to apply under section 4.01(c) of the ALI's Principles, the director must be "informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances," but the director must only "rationally believe . . . that the business judgment is in the best interests of the corporation." The distinction between "reasonable" and "rational" in section 4.01(c) is deliberate. As Comment 'd' to section 4.01 explains:

It is recognized that the word "rational," which is widely used by courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred.

Essentially, the ALI proposes to focus the protective thrust of the business judgment rule on limiting judicial scrutiny of the substance of the directors' decision. The ALI formulates a standard of reasonable belief regarding the process the directors use to reach their decision, or, more specifically, whether directors gathered adequate information before acting. This would appear consistent with the norm of ordinary negligence. When it comes to the substance of the directors' decision, however, the ALI's proposed version of the business judgment rule lowers the standard of care to a rational belief. The ALI's comments suggest this rational belief standard may be similar to an absence of gross negligence.

65. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 2, § 401(c), at 182 (emphasis added).
66. Id. § 401 cmt. d at 185.
67. See, e.g., Aloy v. Mash, 696 P.2d 656, 659 (Cal. 1985) (attorney has obligation to conduct reasonable research before giving an opinion); Ouellette v. Subak, 391 N.W.2d 810, 816 (Minn. 1986) (doctor must use reasonable care to gather information needed to exercise professional judgment).
68. The ALI states that this rational belief test is the same approach as used by a number of cases applying Delaware law. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 2, at § 401(c) cmt. f at 236-37. As explained earlier, Delaware apparently employs a gross negligence standard both as to process and result. E.g., Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986). But see In re J.P. Stevens & Co., 542 A.2d 770, 780-81 (Del. Ch. 1988), appeal refused, 540 A.2d 1088 (Del. 1988).
There are a number of variations on this process-versus-substance theme. All have in common, however, the notion that the business judgment rule calls for less judicial scrutiny of the merits of the directors' decision than of the process the directors used in arriving at the determination.69 One obvious extreme is to conclude that the business judgment rule precludes any review at all of the substance of the decision. The opinion of the New York Court of Appeals in Auerbach v. Bennett70 provides an example of this extreme.

Auerbach involved the decision of a "special litigation committee." Specifically, shareholders of General Telephone & Electronics Corporation brought a derivative suit against directors of the company and its outside accountants. The complaint alleged breaches of fiduciary duty in connection with so-called questionable payments made by the company to overseas public officials and political parties. In response, the board of GTE appointed a committee of three directors, who were not defendants in the derivative action, to determine the position the company should take regarding the suit. The committee, after some investigation, concluded the derivative suit was not in the best interests of the corporation and the corporation moved to dismiss. The court of appeals decided the appropriate response to such a motion was to apply the business judgment rule to the committee's recommendation. More significant to the present discussion, the court then interpreted the rule to preclude any review of the substance of the committee's decision. The court explained:

69. E.g., Stuart R. Cohn, Demise of the Directors' Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 Tex. L. Rev. 591, 607, 615 (1983) (duty of care emphasizes process; review of merits should be limited to whether the decision is consistent with a significant portion of the information possessed by the directors); Dyson, supra note 37, at 369-70 (business judgment rule may usefully embody the idea that diligent directors should not be liable for a bad decision resulting from a lack of skill rather than effort); Charles Hansen, The ALI Corporate Governance Project: Of the Duty of Care and the Business Judgment Rule, a Commentary, 41 Bus. Law. 1237 (1986) (duty of care concerns process and that results should not be not reviewable unless so egregious as to amount to constructive fraud); E. Norman Veasey & Julie M.S. Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case and the ALI Project—A Strange Porridge, 63 Tex. L. Rev. 1483, 1486-87 (1985) (gross negligence is a standard for process; review of merits should be limited to abuse of discretion which equals a lack of a rational business purpose); Statement of the Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations," 49 (Feb. 1983) (on file with author) (Only in the exceptional case where the decision is so bizarre as to cast doubt on the directors' good faith should the merits of the decision rather than the process used to reach it be subject to review.).
70. 393 N.E.2d 994 (N.Y. 1979).
We turn then to the action of the special litigation committee itself which comprised two components. First, there was the selection of procedures appropriate to the pursuit of its charge, and second, there was the ultimate substantive decision, predicated on the procedures chosen and the data produced thereby, not to pursue the claims advanced in the shareholders' derivative actions. The latter, substantive decision falls squarely within the embrace of the business judgment doctrine, involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems. To this extent the conclusion reached by the special litigation committee is outside the scope of our review. Thus, the courts cannot inquire as to which factors were considered by that committee or the relative weight accorded them in reaching that substantive decision.\textsuperscript{71}

Instead, the only review—other than as to subjective good faith—was to the methodologies used by the committee: "The court may properly inquire as to the adequacy and appropriateness of the committee's investigative procedures and methodologies."\textsuperscript{72}

II. IS THE BUSINESS JUDGMENT RULE A "GOOD" RULE?

At first glance, one might be tempted to answer this question by saying it depends upon the interpretation given the business judgment rule. For example, how can one criticize a "rule" which consists of little more than a self-evident statement? Probably no one expects that directors should act as insurers against less than optimum results from all their decisions, any more than one expects such from doctors, lawyers, or others. Accordingly, few would argue with the proposition that the plaintiff must prove some problem of loyalty or care before courts will impose liability on directors. Yet, the very self-evident nature of such a statement suggests that labeling it as some sort of special rule serves little utility.

Moreover, before assuming any problem with the business judgment rule is simply one of overexpansive interpretation, it may be useful to look again at the honest error in judgment rule. In the medical-malpractice area, questions about that rule have arisen in the context of defendants' requests for instructions to the jury that they are not liable for "an honest error in judgment." A growing number of courts

\textsuperscript{71.} Id. at 1002.

\textsuperscript{72.} Id.
have held such an instruction should not be given. The principal concern is that such an instruction can confuse the jurors into focusing on the doctor’s subjective good intentions rather than on whether the doctor’s conduct corresponded to an objective standard of care. The history of the business judgment rule suggests lay jurors are not the only ones who can become confused into focusing upon subjective good intentions by this sort of language. Yet, there may be a greater problem here than simply the language used. There seems to be something in the human mind which rebels at the notion that anything labeled a “rule” could have little or no significance. Hence, it may be impossible to confine a phrase entitled “the business judgment rule” to standing only for a caution concerning the nature of negligence.

Accordingly, the desirability of the business judgment rule rests on one fundamental question: Should directors’ liability require a showing of greater fault than ordinary negligence? In addressing this question one must start with the presumption that the standard of ordinary negligence is correct because it is the norm throughout the law of torts. It is also the norm when dealing with the duty of care of agent to principal. Accordingly, the burden exists on those who would establish a different standard for director liability—whether it is good faith only, gross negligence, or a focus on process rather than substance—to justify the special treatment.

A. EXAMINING THE JUSTIFICATIONS FOR INSULATING DIRECTORS FROM LIABILITY FOR ORDINARY NEGLIGENCE

Over the years, numerous courts and writers have recited a variety of justifications for the business judgment rule insulating directors from liability for ordinary negligence. These rationales fall into four broad categories explored below. The difficulty with these arguments is generally not that they lack any truth. On the contrary, the primary

73. E.g., Demmer v. Patt, 788 F.2d 1387 (8th Cir. 1986); Somer v. Johnson, 704 F.2d 1473 (11th Cir. 1983); Shumaker v. Johnson, 571 So. 2d 991 (Ala. 1990); Wall v. Stout, 311 S.E.2d 571 (N.C. 1984); Rogers v. Meridian Park Hosp., 772 F.2d 929 (Or. 1989); Teh Len Chu v. Fairfax Emergency Medical Assocs., 290 S.E.2d 820 (Va. 1982).

74. [T]o use such a phrase in a charge upon negligence serves only to confuse a jury by implying that only an error in judgment made in bad faith can be actionable. The central issue in the ordinary negligence case is whether the defendant has deviated from the required standard of reasonable care, not his mental state at the time of the conduct.


75. E.g., Keeton et al., supra note 57, at 161, 173.

76. See, e.g., Restatement (Second) of Agency, § 379(1) (1984) (stating that agent has a duty to act with care and skill that is standard in the locality for the kind of work).
1994] BUSINESS JUDGMENT RULE 305

problem is that these rationales prove too much, for they could apply with equal force to numerous other situations in which the rule of ordinary negligence commonly applies.

1. Difficulties with After-the-Fact Review of Business Decisions

The most traditional arguments for insulating directors from liability for ordinary negligence center upon the difficulties which can attend after-the-fact judicial review of business decisions. These arguments often begin with the observation that because business decisions involve taking risks, many decisions by directors end up producing a loss for the company. Such an observation, however, hardly distinguishes business decisions from decisions in numerous other contexts, such as medicine or law, which often involve taking calculated risks and in which many decisions will also produce harm or loss. More fundamentally, this observation is not inconsistent with the premises underlying the negligence standard. Specifically, the mere fact that a decision involves taking risks or ultimately results in a loss does not make the decision negligent. Spinning off from Judge Hand's famous formula, if the magnitude of gain expected from a board decision, multiplied by the probability measured ex ante of achieving the gain, exceeds the magnitude of loss risked by the decision, multiplied by the probability of the loss, than the decision presumably is reasonable. Accordingly, a negligence standard should

78. See infra notes 104-06 and accompanying text.
79. See supra notes 31-35 and accompanying text.
80. United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947) (holding that liability depends upon whether the burden of prevention is less than the probability of the accident multiplied by the severity of the injury).
81. Stated algebraically: if \( P_g \times M_g > P_l \times M_l \), then the decision is reasonable (where \( P_g \) = probability of gain; \( M_g \) = magnitude of gain; \( P_l \) = probability of loss; and \( M_l \) = magnitude of loss). More realistically, there can be a number of potential outcomes from a business decision. In that case, the formula becomes: if \( (P_{g1} \times M_{g1}) + (P_{g2} \times M_{g2}) + \ldots + (P_{gk} \times M_{gk}) > (P_{l1} \times M_{l1}) + (P_{l2} \times M_{l2}) + \ldots + (P_{ln} \times M_{ln}) \), then the decision is reasonable (where \( P_{g1} \) through \( P_{gn} \) and \( M_{g1} \) through \( M_{gn} \) are the probabilities and magnitudes of the various possible outcomes). This approach is perhaps simplistic because it treats any decision yielding a positive net expected return as reasonable without regard to how the expected return would compare with other investments of similar risk. See Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 N.Y.U. L. REV. 1045, 1062-64 (1991) (suggesting that the failure to invest so as to achieve an expected return commensurate with risk as measured by the market "risk-return frontier" can breach a fiduciary's duty of care). Nonetheless, the point remains that there is nothing presumptively negligent about taking risks. One might also note that the Hand formula actually works better when dealing with business risks than with accidents. With business risks, there is no need to put a dollar figure on the magnitude
neither deter the taking of desirable risks nor punish simply bad results.

The problem, however, is that this sort of formula is easier to recite than actually to apply in an after-the-fact judicial proceeding. Such a proceeding is neither infallible nor cost-free. Rather, there is always the concern that a fact finder with the benefit of hindsight will confuse bad results with an unreasonable decision. Moreover, even if the defendant prevails, victory may come only after expensive litigation. Accordingly, the argument often goes, without protection from liability for ordinary negligence, directors have an incentive to avoid potentially more desirable higher-risk activities in favor of less profitable but more guaranteed undertakings.

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INVESTMENT A

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Although A is clearly "worth" more than B, it is riskier because it is more volatile. Diversification lessens the volatility by allowing investors to invest in 20 or 200 A's which will tend to guarantee a total result near the value. Shareholders are thus better off with the various firms selecting A over B, although after the fact they will complain in each case of the 2.6 loss. If the courts did not abide by the business judgment rule, they might well penalize the choice of A in each such case and thereby unknowingly injure shareholders generally by creating incentives for management always to choose B.
Yet, in itself, this argument also does not distinguish business decisions from decisions in medicine, law, or a myriad of other undertakings to which the standard of ordinary negligence applies. Indeed, this line of reasoning is part of complaints by doctors and various other groups of prospective defendants who assert that the high cost of even a successful defense and the propensity of fact finders to confuse bad results with negligence have created a “malpractice crisis” and a need to reform the tort system. Hence, if one is to defend a business judgment rule that embodies a different standard of liability for directors, one must point to ways in which after-the-fact judicial review of business decisions poses greater difficulty than found in other areas. Specifically, the burden exists to show that there is a greater prospect for error in assessing the reasonableness of a business decision or that incentives to avoid risk pose some greater harm when dealing with business decisions. Those who defend a different standard for directors have made both claims.

Courts and writers have pointed to two factors which might make after-the-fact judicial review of business decisions more prone to erroneous factual conclusions than review of decisions in other areas. To begin with, judges and juries generally are not business experts. Yet, this perceived lack of competence has not prevented exacting judicial review under the intrinsic-fairness test of business decisions in which directors have a conflict of interest. More fundamentally, such lack of judicial expertise does not distinguish business decisions from medicine and innumerable other fields in which the negligence system holds sway.

As stated before, Investment A should not result in liability under an ordinary negligence standard even if it produces the -13 loss. See supra note 81 and accompanying text. The concern lies with erroneous findings of liability and the expense of a successful defense.

85. E.g., William J. Curran, Professional Negligence—Some General Comments, 12 Vand. L. Rev. 533, 591 (1959) (stating that the professionals’ most disturbing fear regarding malpractice liability is that the law will call them to account simply because the result obtained was bad); David Mechanic, Some Social Aspects of the Medical Malpractice Dilemma, 1975 Duke L.J. 1179, 1181-83; Jeffrey O’Connell, Neo-No-Fault Remedies for Medical Injuries: Coordinated Statutory and Contractual Alterations, 49 Law & Contemp. Probs. 125 (1986).


If judicial expertise cannot justify different treatment, perhaps there is something about the nature of business decisions which renders review more speculative. A number of courts and writers have made the argument that each business decision is unique, heavily intuitive, and judgmental. These qualities, such courts and writers assert, both undermine the accuracy of after-the-fact review and are not true of other fields.90 For example, the principal reporter for the ALI Corporate Governance Project argued in a recent article that medical, unlike business, decisions involve established protocols which can guide both fact finders in accurately determining negligence and prospective defendants in avoiding the same.91

There are a couple of difficulties with this argument. First and foremost, it is factually wrong. For one thing, the very existence of extensive formal business education would seem to contradict the notion that no norms guide the making of business decisions.92 The idea that business decisions represent an intuitive swamp entirely beyond the ken of later reviewers seems especially questionable for actions at the board of directors level. Since directors act as a board, their decisions involve group deliberations rather than a single individual’s unarticulated intuitive judgment, as might be the case with other professionals.93

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90. E.g., Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); Auerbach, 393 N.E.2d at 1000 (N.Y. 1979); Vessey & Manning, supra note 11, at 932.
91. Eisenberg, supra note 32, at 963-64.
92. E.g., J. Gordon Christy, Corporate Mismanagement As Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty, 21 Hous. L. Rev. 105 (1984). For example, one of the common areas involving board approval, and a frequent source of legal challenges to the board's decision, is the buying and selling of businesses or major business assets. E.g., Cohn, supra note 69, at 596-97. Here, one of the primary issues is price. E.g., Franklin A. Gevurtz, Business Planning 796-804 (1991). While business valuation is certainly more of an art than a science, to say it is an art without any established guidelines or methodologies is to ignore huge quantities of available literature. E.g., HAROLD BIERMAN, JR. ET AL., QUANTITATIVE ANALYSIS FOR BUSINESS DECISIONS (8th ed. 1991); ARTHUR S. DIEWING, FINANCIAL POLICY OF CORPORATIONS (5th ed. 1953); EUGENE F. FAMA & MERTON H. MILLER, THE THEORY OF FINANCE (1972); DENNIS E. LOGUE, HANDBOOK OF MODERN FINANCE (2d ed. 1990); JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY (5th ed. 1980); J. FRED WESTON & EUGENE F. BRIGHAM, MANAGERIAL FINANCE (4th ed. 1972).
93. See, e.g., William H. Rodgers, Jr., Negligence Reconsidered: The Role of Rationality in Tort Theory, 54 S. Cal. L. Rev. 1, 6-7 (1980). This is not to say that group deliberations yield better results; merely that there is more likely to be an articulated rationale or rationales for the group's action. The fact that directors act as a group may raise causation questions concerning a particular director's liability, e.g., Francis v. United Jersey Bank, 432 A.2d 814, 826-29 (N.J. 1981), and also may raise questions concerning the reasonableness of reliance upon others, e.g.,
If business decisions are not completely an unreviewable guesswork swamp, it is even more a myth to suppose medical or other professional decisions have been routinized down to the scientific application of accepted protocols. For example, most doctors will admit that a certain percentage of their patients are "not in the book," by which doctors mean the patients' complaints and symptoms do not fall into any familiar categories of diagnosis and treatment. While different doctors place the proportion of such patients at different levels, this level may be as high as eighty-five percent.94 With regard to the legal profession, one of the primary goals of law school is to prepare students to deal with situations where there is substantial uncertainty.95 Even in accounting, the California Supreme Court recently noted how auditing is a complex process requiring discretion and judgment at every stage.96 In fact, law, medicine, business, and other professions may be largely alike in that they involve a substantial degree of what one author has labeled "knowing in action." In other words, the professional undertakes actions in unique situations based upon intuition and experience, without being able to articulate the exact reason for the course of action.97 To the extent this sort of intuitive "knowing in action" does not lend itself to an accurate after-the-fact judicial assessment of reasonableness, then perhaps there is a need to rethink the standards of malpractice generally. Such tort-law reform is well beyond the scope of this Article. The important point for present purposes is that business decisions do not represent a distinctly intuitive field in a way which renders them particularly inappropriate for judicial review; on the contrary, business decisions are very similar in this regard to decisions by other professionals.

Yet, even if it was true that business decisions are more judgmental and leave less guidance for later reviewers than found in other fields, this assertion would not justify the conclusion that directors

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94. DONALD A. SCHON, THE REFLECTIVE PRACTITIONER: HOW PROFESSIONALS THINK IN ACTION 16 (1983); see also Randall R. Bovbjerg, Medical Malpractice on Trial: Quality of Care is the Important Standard, 49 LAW & CONTEMP. PROBS. 321, 329 (1986)(measuring the quality of medical care is especially difficult given that medicine is as much an art as a science and given the complexities of the human organism); Mechanic, supra note 85, at 1182 (stating that standards of medical practice are ambiguous).

95. E.g., GEVURTZ, supra note 92, at 20; RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE 811-12 (3d ed. 1989); James Boyd White, Law Teacher’s Writing, 91 MICH. L. REV. 1970, 1972 (1993); see also infra note 98 and accompanying text.


97. SCHON, supra note 94, at 49-50.
need added insulation from liability for ordinary negligence. To understand why, it is useful to consider the area of legal malpractice. One part of legal practice which is especially intuitive and judgmental is trial strategy. What prospective jurors to excuse, what witnesses to call, what questions to ask (or not ask), what objections to forgo, what areas to emphasize in opening and closing arguments, and, indeed, what overall theory of the case to pursue are all subjects upon which the attorney must exercise judgment guided in large part by intuition and experience (and often with little or no time for reflection). If, in fact, highly judgmental areas are particularly prone to judicial second guessing that confuses bad results with negligence, then one would expect such trial decisions to be the grist for innumerable legal malpractice suits. This is especially true given that trials inevitably produce losers, thereby providing a steady stream of prospective malpractice plaintiffs. Yet, challenges to trial decisions do not constitute the predominant source of legal malpractice claims and are rarely successful. It is not difficult to deduce why. The more judgmental and less subject to consensus a given decision is, the more difficult it is for the plaintiff to prove a given decision was unreasonable, much less that a different decision necessarily would have produced a better result.

This raises an important point missed by those who worry that a lack of accepted protocols or guidelines for business decisions will leave directors too much at risk under an ordinary negligence standard. This point is that a lack of guidelines for determining the reasonableness of actions most hurts the party with the burden of proof—the plaintiff. The experience with trial attorneys also suggests that an ordinary negligence standard would not mean directors would face a lawsuit every time they made a decision.

99. E.g., Mallen & Smith, supra note 95, at 157 (stating that missed time limitations make up the largest source of legal malpractice claims; most litigation related legal malpractice claims relate to ministerial, non-judgmental errors).
102. For an assertion that applying conventional tort standards to directors' decisions will yield boundless litigation, see Kennedy, supra note 77, at 630-31.
If there is nothing about business decisions which makes an after-the-fact judicial review of reasonableness inherently less accurate than in other areas, one could still argue that deterrence of risk taking creates greater harm in the business context. Yet, there is little basis for such an argument. True, risk taking is important in business. But it is also important in medicine, law, and a host of other fields. For example, anyone who has been through the experience of discussing surgery in a doctor’s office comes to realize that medical treatment inherently involves the taking of calculated risks. The same is true when deciding litigation and trial strategy and throughout much of the practice of law. Indeed, it is difficult to conceive of an area in which decisions do not involve a balancing of risks.

Admittedly, the ultimate decision to take risks in the medical or legal fields normally lies with the patient or client. Accordingly, one might argue that medical and legal professionals can insulate themselves from liability by obtaining informed consent. Such an argument, however, misunderstands the role of informed consent in malpractice litigation. Patients who have suffered injury by virtue of arguably reasonable treatment have used the lack of their informed consent as an independent basis for recovery. One cannot find cases, however, in which doctors have been able to use their patients’ consent to prevent liability for an unreasonable choice of treatment.

103. E.g., Veasey & Manning, supra note 11, at 931-32.
104. E.g., Staff of Senate Subcomm. on Executive Reorganizations of the Senate Comm. on Gov’t Operations, 91st Cong., 1st Sess., Medical Malpractice: The Patient Versus the Physician 453-56 (Comm. Print 1969) [hereinafter Senate Subcomm.]; see also Robert H. Brooks et al., The Relationship Between Medical Malpractice and Quality of Care, 1975 DUKE L.J. 1197, 1209 (stating that the increasing effectiveness of modern medical therapies also has increased their possibilities of doing harm to the patient); Glen O. Robinson, The Medical Malpractice Crisis of the 1970s: A Retrospective, 49 LAW & CONTEMP. PROBS. 5, 11-12 (1986) (same).
105. E.g., Robert E. Keeton, Trial Tactics and Methods 96-98 (2d ed. 1973); see also infra notes 170-75 and accompanying text.
106. E.g., Keeton et al., supra note 57, at 179; see also Walter J. Blum & Harry Kalven, Jr., The Empty Cabinet of Dr. Calabresi: Auto Accidents and General Deterrence, 34 U. Chi. L. Rev. 239, 255 (1967) (pointing out that excessively cautious driving itself creates safety hazards).
108. E.g., Eisenberg, supra note 32, at 964 n.53.
110. Nor is it realistic to suggest that professionals can use the consent process to avoid exercising any judgment by laying out all the options and all the relevant learning about each option and then letting the patient or client play doctor or lawyer. The patient or client typically wants a recommendation—that is what one employs the professional for. This is why the cases
Moreover, directors concerned about a particularly risky decision could seek consent from the shareholders.\footnote{111}

Overall, the concern that liability for ordinary negligence will deter directors from taking worthwhile risks sounds remarkably like the lament of doctors who complain that the threat of malpractice suits has forced them to engage in "defensive medicine" with the result of unnecessarily increased costs\footnote{112} and the avoidance of worthwhile but more risky medical treatments.\footnote{113} Similar laments can be heard coming from other professionals faced with liability for negligence.\footnote{114} The concern about director liability and risk taking may well be valid. It is not, however, unique.

2. Nature of the Damages

A second group of arguments made in favor of a special standard of liability for directors focuses on the damages suffered by the corporation. Specifically, some writers have attempted to justify such a standard by noting that, unlike medical malpractice or many other torts which cause physical injuries, director gaffes cause only monetary loss.\footnote{115} In addition, a number of writers have expressed concern about the potentially huge dollar losses which a director's decision speak of informed consent—consent to a recommended procedure—rather than informed selection of a procedure by the patient. \textit{E.g.}, Sard, 379 A.2d at 1020 (Md. 1977) (holding that there is a duty to disclose nature of "proposed treatment"). In addition, even if consent can avoid a malpractice claim for the choice of a procedure, it still leaves the physician at risk to a claim of negligently carrying out the procedure. This, in turn, can create an incentive to avoid higher-risk procedures where a jury might confuse a bad outcome with negligent performance.

\footnote{111}{\textit{See}, \textit{e.g.}, Smith \textit{v.} Van Gorkom, 488 A.2d 858, 889 (Del. 1985) (suggesting that shareholders can ratify negligence). Much like the situation with other professionals, attempts by directors to seek consent may raise issues of full disclosure and may not be practical. \textit{Compare id.} at 890-93 (holding that directors must disclose germane facts) \textit{with} Crain, 443 A.2d at 558 (holding that physicians had to disclose material risks). \textit{See}, \textit{e.g.}, Cobbs \textit{v.} Grant, 502 P.2d at 10-12 (holding that a doctor may forgo obtaining informed consent of a patient in an emergency or when disclosure of all risks otherwise might be detrimental to the patient's health).}

\footnote{112}{\textit{E.g.}, Glen O. Robinson, \textit{Rethinking the Allocation of Medical Malpractice Risks Between Patients and Providers}, \textit{49} \textit{Law \& Contemp. Pros.}, 173, 176-77 (1986) (citing surveys in which between 50-70 percent of all physicians claim to practice defensive medicine and an AMA estimate that the annual cost of defensive medicine exceeds $15 billion).}

\footnote{113}{\textit{E.g.}, \textit{Senate Subcomm.}, \textit{supra} note 104, at 6-7, 453; James W. Brooke, \textit{Medical Malpractice: A Socio-Economic Problem from a Doctors [sic] View}, \textit{6} \textit{Williamette L.J.}, 225, 231 (1970); Brooks et al., \textit{supra} note 104, at 1213, 1217; Bovbjerg, \textit{supra} note 94, at 324.}

\footnote{114}{\textit{E.g.}, Donna R.H. Walters, \textit{New Liability Twist Has Lawyers, Accountants Scurrying}, \textit{L.A. Times}, Mar. 29, 1992, at D1.}

\footnote{115}{\textit{E.g.}, Eisenberg, \textit{supra} note 32, at 964.}
could cause. This, in turn, leads to the assertion that liability for such large amounts could deter qualified individuals from serving on boards—especially given the relatively small compensation received by outside directors.

It is difficult to find justification in such arguments for a different standard of liability for directors. Directors are hardly unique among prospective tort defendants in that their negligence is likely to cause economic loss rather than physical injury. To name one obvious group, the same could be said of attorneys.

Neither is the concern about the size of damage awards unique to directors. Doctors and other professionals have repeatedly expressed similar concerns about the size of awards against them. In fact, a comparison of actual awards against negligent directors versus other professionals might suggest directors have little to complain about.


118. This, however, would not explain application of the business judgment rule to well compensated management directors. Moreover, any notion that the standard of care should be proportional to the amount of compensation is inconsistent with general principles of tort law. See, e.g., Le Juene Road Hosp. v. Watson, 171 So. 2d 202 (Fla. Dist. Ct. App. 1965).

119. E.g., Smith v. Lewis, 530 P.2d 589 (Cal. 1975) (involving person's loss of interest in retirement plan as a result of her attorney's negligence); see also Spherex, Inc. v. Alexander Grant & Co., 451 A.2d 1308 (N.H. 1982) (involving an accountant's negligence that resulted in a financial loss for a creditor who made a loan in reliance on negligently prepared financial statements); City of Eveleth v. Ruble, 225 N.W.2d 521 (Minn. 1974) (involving an engineer's negligence that cost the city money to redo an intake system).


121. After reviewing the judicial decisions in which directors were held liable for negligent mismanagement—rather than for inattention or conflict of interest—a 1983 article found the highest award was only $547,021, and this award was subject to contribution among sixteen defendant directors. Cohn, supra note 69, at 629 n.189. Part of the reason for this is that difficulties in proving causation often cut off the more extreme damage claims against directors. Id. at 629; see also Barnes v. Andrews, 298 F.2d 614 (S.D.N.Y. 1924) (holding that the plaintiff failed to show that the director's neglect caused business losses). By way of comparison, the average award in a medical malpractice case in 1980 was $404,726, in 1985 almost $1.2 million, and in 1986, almost $1.5 million. The highest verdict in each of these years was approximately $6.7 million, $12.7 million, and $15.8 million, respectively. Note, The Applicability of Experience Rating to Medical Malpractice Insurance, 38 Case W. Res. L. Rev. 255, 260 n.37 (1987). Multimillion dollar awards against negligent attorneys also have become increasingly common. E.g., Malpractice Update, 12 Cal. Law., Sept. 1992, at 78 (reporting verdicts of $8.2, $2.7, and $1 million). Recently, an Arizona jury returned a verdict against the accounting firm of Price, Waterhouse for $338 million based upon negligent audits of a bank (although this verdict was subsequently set aside for other reasons). Black Days for Accounting Firms, WALL ST. J., May 22, 1992, at A10.
Moreover, the threat that large awards will drive individuals from service on boards of directors finds its parallel among like claims by medical and other professionals. For instance, some argue that the cost of malpractice suits is driving individuals away from certain areas of medical practice\textsuperscript{122} or many small accounting firms out of auditing.\textsuperscript{123} In any event, if potentially draconian damage awards are the problem, the logical solution does not lie in fiddling with the standard of liability. Instead, the solution would be to limit the amount of recovery.\textsuperscript{124} This, in fact, has been an approach followed by a number of states when dealing with the concerns of doctors.\textsuperscript{125}

3. Nature of the Plaintiff

A third group of arguments in favor of less liability for directors centers on the nature of the plaintiff in a derivative suit. Several factors generally make the shareholder who brings such a suit a less than sympathetic victim. To begin with, normally the shareholder has voluntarily entered into the relationship with the directors.\textsuperscript{126} After all, no one forced the shareholder to buy stock, and the stockholders as a whole were the people who elected the board. Accordingly, if shareholders do not like the way the directors manage their company, they may either elect someone else or sell out. Further, according to currently popular financial theory, shareholders should protect themselves against the risks of mismanagement in any one company by holding a diversified portfolio of stock.\textsuperscript{127} Finally, the plaintiff in a derivative suit often is a fairly nominal shareholder who is serving primarily as a front for an attorney pursuing the action for the sake of fees.\textsuperscript{128} This fact, in turn, raises suspicions that plaintiffs may bring actions alleging a breach of the duty of care on only a slender basis and when the suit is not in the best interest of the corporation.\textsuperscript{129}


\textsuperscript{123} Lee Berton, Legal-Liability Awards are Frightening Small CPA Firms Away from Audit, WALL ST. J., Mar. 3, 1992, at B1.

\textsuperscript{124} E.g., Conard, supra note 116, at 914. Virginia has done this for directors of its corporations. VA. CODE ANN. § 13.1-692.1 (Michie 1989).

\textsuperscript{125} E.g., CAL. CIV. CODE § 3333.2 (West 1992); KAN. STAT. ANN. § 60-3407 (1990); UTAH CODE ANN. § 78-14-7.1 (1992); W. VA. CODE § 55-7B-8 (Supp. 1992).

\textsuperscript{126} E.g., Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); Lattin, supra note 25, at 277.

\textsuperscript{127} E.g., Joy, 692 F.2d at 886; Phillips, supra note 83, at 701-02.


\textsuperscript{129} E.g., Fischel, supra note 62, at 1443.
Each of these arguments, however, has a number of shortcomings. The fact that shareholders have entered into a voluntary relationship with the directors is not different from most situations involving malpractice claims. The same is generally true of patients with doctors, clients with attorneys, and a host of other situations out of which negligence actions may arise. Indeed, to suggest that a voluntary relationship decreases the standard of care stands the historical development of tort law on its head. Even today, in a number of contexts such as law or accounting, privity (a voluntary contractual relationship) remains an important, if not necessary, factor in establishing any duty of care at all. Moreover, the voluntary aspect of the relationship cuts both ways. Just as no one forced the shareholders to buy their stock or elect the directors, no one forced the directors to take the job.

The argument regarding diversification is more sophisticated, but ultimately is not more persuasive. To begin with, owning a portfolio of stocks only dilutes, but does not eliminate, the effects of mismanagement on the individual shareholder. In addition, the ability to protect oneself from director negligence by diversification is not entirely unique. Individuals dealing with doctors or other professionals can, and often do, get a second opinion on various judgment calls. More broadly, medical and disability insurance cushion the financial risk from personal injury much as diversification cushions the loss from bad investments. Admittedly, there are practical limits on the ability to always get a second opinion whenever dealing with a professional or to fully insure against injury. Similarly, not every investor can or will hold an efficiently diversified portfolio of stocks. This is particularly the case when dealing with closely held corporations,

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130. See, e.g., Keeton et al., supra note 57, at 660-61.
133. E.g., Lattin, supra note 25, at 274.
134. Diversification can only provide full protection against bad results from a director decision that had a net positive expected return (in other words, a decision that should not be considered negligent, see supra note 81). In that case, the positive actual returns from those decisions that pan out should eventually more than offset the losses from those that, because of bad luck, fail. See supra note 84. On the other hand, if directors negligently make decisions with a net negative expected return, diversification can at best dilute the losses.
where it is quite common for shareholders to tie up a substantial percentage of their wealth in the stock of one company. Moreover, whatever one thinks of the acumen of the numerous investors who do not diversify, it seems questionable whether courts should gear rules of law to demand that individuals follow a particular investment strategy.

Most fundamentally, however, the diversification argument proves too much. Holding diversified portfolios also dilutes the individual stockholder's risk from any given company becoming the victim of breaches of contract by those the company does business with, of illegal trade practices by the firm's competitors, of tortious activities by those outside the firm, or of other conduct which might harm and create a cause of action in favor of a corporation. Does anyone suggest the law abolish the ability of corporations to bring lawsuits, since their stockholders could always diversify to minimize such risks? The diversification argument—indeed, the whole cluster of arguments which focus on the plaintiff shareholder—ignores the fact that one of the original purposes for creating the legal fiction of corporate entities was to allow an entity to have rights and assert causes of action independent of its owners.

This fact is often obscured because shareholders suing derivatively on behalf of the corporation bring many, if not most, suits asserting director negligence. This makes it very tempting to attack perceived abuses in derivative suits by creating special liability rules, such as a business judgment rule, which insulates directors from liability for ordinary negligence. It is important to keep in mind, however, that liability rules will affect actions which are not shareholder derivative suits, such as when a trustee in bankruptcy or even the corporation's elected management decide to sue. Accordingly, if there is a

137. E.g., Latting, supra note 25, at 65.
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problem with shareholder derivative suits, the answer lies in attacking the problem directly.141

4. Utility of Compensation or Deterrence

The final series of arguments made in favor of limiting the liability of directors for negligence—even, according to some writers, to the point of abolishing any claim for breach of the duty of care142—involve an analysis of the economic utility of liability in this context. This analysis takes as a given the two goals often expressed for tort recovery: compensation and deterrence.143

A number of writers have argued that director liability for negligence poorly serves the goal of compensating corporations injured by such negligence.144 As a factual matter, recovery rarely comes from the negligent directors themselves. Rather, if there is a settlement, the corporation often will indemnify the directors.145 Alternately, liability insurance purchased by the corporation for its directors and officers commonly funds the payment. In the former instance, all that happens is that money makes a circuit as the corporation pays for its own recovery by indemnifying the defendants. Yet, it is not that simple or harmless since, as the money makes this circuit, much of it is lost to transaction costs such as attorneys fees, which the corporation also pays.

With liability insurance the loop is longer, but exists nevertheless as the insurance company uses premiums paid by corporations purchasing policies for their directors and officers to fund recovery. Of course, in this instance, it is not solely the recovering corporation which pays. Instead, all companies purchasing policies for their officers and directors have paid premiums. This is the risk-spreading

144. E.g., Conard, supra note 116, at 909-12.
145. Corporations statutes commonly allow companies to indemnify their directors for expenses incurred in defending derivative actions brought against the directors and, subject under many statutes to court approval, for sums paid to settle such actions. E.g., Cal. Corp. Code § 317(c) (West 1990); Del. Code Ann. tit. 8, § 145(b) (1991); N.Y. Biz. Corp. Law § 722(c) (McKinney Supp. 1993). But see M.B.C.A. § 8.51(e) (stating that corporation cannot indemnify payments made to itself in a settlement).
function of insurance, the advantage of which is that unpredictable large losses typically produce a disproportionately greater harm than predictable small expenditures. Some writers have questioned whether this risk-spreading function is important in the corporate context given the ability of shareholders to limit risk by holding a diversified portfolio of stocks. This harkens back to the diversification argument discussed earlier. More fundamentally, however, risk spreading does not require courts to impose liability on directors. If enough corporations desire to insure against losses resulting from unreasonable director decisions, presumably they can voluntarily buy policies which do so.

In any event, even if recovery does not come from indemnity or insurance, it is open to debate just how desirable it is for directors to compensate their corporation. For one thing, corporations probably have more money than their directors and thus can better afford the loss. Moreover, directors may be poor at spreading the risk since they do not work for a large number of corporations.

One could, of course, quibble with portions of this sort of analysis. For example, statutes which allow a corporation to indemnify its directors for payments the directors agree to make to the corporation seem rather silly. Accordingly, maybe the problem lies with such statutes, rather than with director liability.

The fundamental problem with this whole line of reasoning, however, is not its invalidity, but rather its universality. Similar arguments provide the underpinnings for various no-fault proposals made to replace the negligence system in areas such as automobile accidents. The fact of the matter is that as a scheme solely for compensation (at least in the sense of avoiding financial hardship due to accidents), tort recovery is inefficient and probably makes little sense.

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147. E.g., Coffee, supra note 140, at 806; Phillips, supra note 83, at 702 n.177.
148. See supra text accompanying notes 127, 134-37.
149. Coffee, supra note 140, at 805.
150. Id. at 802.
151. In fact, the most recent version of the Model Business Corporation Act does away with such circular payments. M.B.C.A. § 8.51 cmt. 5 (1992).
The transaction costs to achieve compensation are high and compensation depends on fault rather than need.\(^{153}\) A more efficient way to achieve compensation is simply for individuals to purchase medical, disability and property-loss insurance, supplemented or supplanted if necessary by government-provided insurance. The fact that compensation may make little sense as a goal of negligent-director liability is simply a corollary of this broader phenomenon.

Given the above discussion, it is not surprising that many writers have sought to justify director liability for negligence primarily on deterrence rather than compensation grounds.\(^{154}\) Within the last decade or so, however, a number of writers principally associated with the law-and-economics movement have questioned the necessity of director liability to achieve deterrence.\(^{155}\) They argue that a number of economic incentives other than fear of liability exist for directors to make careful and reasonable decisions. These incentives include stock ownership by directors in their corporation, compensation schemes which tie financial rewards to corporate performance, the desire of officers and directors to develop and preserve their reputations for business acumen so as to advance their individual careers, and the fear that poor decisions will make the corporation a takeover target and result in the current directors losing their positions.

Other writers have questioned the efficacy of these incentives.\(^{156}\) For example, many of these incentives depend upon poor director decisions adversely affecting the market price for the corporation's stock. Such a drop, in turn, lowers the value of shares owned by the directors, decreases the financial rewards under common compensation schemes such as stock options, which tie rewards to stock performance, and makes the corporation vulnerable to a takeover. This linkage is absent in privately held corporations, where there is no


\(^{154}\) E.g., Michael Bradley & Cindy A. Schipani, \textit{The Relevance of the Duty of Care Standard in Corporate Governance}, 75 IOWA L. REV. 1, 16-35 (1989); Cohn, supra note 69, at 601-02.


\(^{156}\) E.g., Dierdre Burgman & Paul N. Cox, \textit{Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the Trans Union Case}, 11 J. CORP. L. 311, 355-57 (1986); cf. Bradley & Schipani, supra note 154 (using abnormal stock return study to suggest duty of care enhances shareholder value).
active market for the company's shares. More broadly, the link between specific board decisions and stock prices in many instances might be sufficiently attenuated so as to undercut the efficacy of these incentives. Cynics might also suggest that career advancement within the corporate world depends in many instances upon a whole host of factors other than making good business decisions.

The purpose of this Article is not to enter this debate. Rather, consistent with the general theme of this section, the larger flaw in the argument about other incentives is that it does not distinguish director liability from other contexts in which similar assertions could be made. For example, professionals often face market incentives for good performance. This may be most visible for trial attorneys whose reputations often hinge upon winning.

Another example may hit even closer to home for most readers. Consider the incentives automobile drivers have to drive carefully. While these lack the ring of "the market for corporate control," they would seem nevertheless powerful. Most significant could be simply the risk to the driver's personal safety of an accident. There are also the criminal penalties imposed for the sort of conduct which often leads to accidents, such as speeding or driving while intoxicated, regardless of whether the conduct produces an accident. Given these incentives, it is unclear how much more careful the average driver is because of concern with tort liability—or, indeed, whether in the course of driving most individuals even give much thought to tort liability. In fact, if drivers did react to the threat of tort liability, there could well be over-deterrence since liability-insurance rates often go up based upon the driver having had an accident, whether or not it was the driver's fault. Of course, the sorry fact is that despite

158. The names Bailey, Belli, Darrow, and Spence come quickly to mind.
159. E.g., California Highway Patrol, 1990 Annual Report of Fatal and Injury Motor Vehicle Traffic Accidents 46 (reporting that driving under the influence is the largest primary cause of fatal traffic accidents and speeding is the next largest primary cause).
160. But see Elizabeth M. Landes, Insurance, Liability and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault Accidents, 25 J.L. & Econ. 49 (1982) (finding an increase in auto fatality rates when no-fault plans do away with tort suits). This result may, however, simply reflect an increase in driving when no-fault plans lower the cost of auto insurance, rather than an increase in negligent driving as a proportion of the whole. Sugarman, supra note 143, at 589.
161. E.g., Blum & Kalven, supra note 106, at 257.
these incentives one seems to constantly encounter negligent driving.  

B. TESTING THE JUSTIFICATIONS IN SPECIFIC SITUATIONS

Perhaps the ultimate test of these various justifications for a special liability standard for directors is to examine whether they would be persuasive in distinguishing between directors and other defendants in specific contexts. Consider first the situation in Smith v. Van Gorkom. One aspect of the case relevant here is the guidance the directors of Trans Union received from an outside counsel brought in to advise them on the proposed sale of the company. The attorney evidently did not warn the directors they were about to breach their duty of care by acting on the limited information before them. On the contrary, the attorney purportedly advised the board members that they did not need an investment banker's fairness opinion regarding the proposed sale and, what is more, he stated they might be sued if they voted not to sell.

These facts lead one to wonder what would have happened had either the directors or the shareholders sued this attorney for malpractice. The standard against which the court would have measured the attorney's advice presumably would be the familiar skill and care ordinarily possessed and exercised by attorneys in the locality. No court has ever suggested the business judgment rule would provide a defense for a corporation's outside counsel. In contrast, the Delaware Supreme Court held that under the business judgment rule the

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162. For an argument that tort liability is generally ineffective at deterring negligent conduct see Sugarman, supra note 143, at 564-81.
163. 488 A.2d 838 (Del. 1985).
164. Id. at 881. The court characterized the attorney's purported advice as literally true. This was being too kind. Whether or not the advice was literally true, the failure to warn the directors that they were about to breach their duty by acting on inadequate information clearly raises the issue of malpractice. See, e.g., Bukoskey v. Walter W. Shuham CPA, P.C., 666 F. Supp. 181 (D. Alaska 1987).
165. Whether the appropriate plaintiffs would be the directors, the shareholders, or both raises the question to whom the corporate counsel's duty runs. For present purposes, however, it is unnecessary to resolve which party should sue, because the concern here lies with the standard for liability to anyone.
166. See, e.g., McClain v. Farone, 369 A.2d 1090 (Del. 1977); MALLEN & SMITH, supra note 95, at 856-57. While some archaic legal-malpractice cases refer to a standard of gross negligence, this usage has disappeared. Id. at 884-87.
167. Cf. Holland v. Stenhouse, 1991 WL 30138 (N.D. Ill. 1991). In this case, the trustee for a bankrupt insurance company sued both the former directors for breach of their duty of care and the company's attorney for legal malpractice for, among other things, failing to advise the directors of their duty. The directors moved to dismiss based upon Delaware's business judgment
directors of Trans Union could not be liable unless they were grossly negligent. Why the difference? Can any of the previously discussed justifications explain such a result?  

To begin with, would after-the-fact judicial review of the attorney's advice pose any lesser problem here than did review of the directors' decision? The decision of what and how much legal advice to give is a question of judgment. In *Van Gorkom*, the attorney had to weigh the risk (ultimately realized) that he would fail to warn the directors of an action which would lead to their liability versus the risk that if he urged too much caution upon the directors they could lose the opportunity for a highly desirable sale. This substantially parallels the judgment the directors of Trans Union had to make. Indeed, it is difficult to see—especially given the narrow margin by which the directors lost this case, as well as the general uncertainty in this whole area of law—how the attorney's decision was much less intuitive and judgmental than the directors'. Litigation over whether the attorney negligently advised the Trans Union board would risk the fact finder confusing bad results (the board was held liable) with negligence and would be expensive even if the attorney won. This prospect, in turn, creates an incentive for attorneys to avoid the risk of liability for themselves by always warning the client of any potential liability. There is no indication any party considered the business judgment rule at all relevant to the claim against the attorney.

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169. One might be more sympathetic to the directors than the attorney because they were operating based upon his poor advice. This, however, goes to the question of whether there was reasonable reliance upon advice so as to preclude a finding of negligence. *E.g.*, Cal. Corp. Code § 309(b) (West 1992). It does not justify applying a standard for liability other than ordinary negligence. *See e.g.*, Frances T. v. Village Green Owners Ass'n, 723 P.2d 573, 584 (Cal. 1986) (holding that directors' reasonable reliance on expert advice should be taken into account under an ordinary negligence standard).


171. The directors were meeting on Saturday; the offer expired Monday morning. 488 A.2d at 867.

172. The Delaware Supreme Court's decision was 3-2. Id. at 888.

173. See *supra* text accompanying notes 53-60.

174. Admittedly, one might distinguish the attorney, who was only advising, from the directors, who were deciding whether to delay and seek more information. It is unrealistic, however, to argue the corporation's attorney does not need to exercise judgment in giving advice because the ultimate decision rests with the board. For one thing, it is questionable whether the Trans Union board would have had the nerve to go ahead with immediate approval when confronted with an attorney's opinion that it faced liability. *Cf.* SEC v. National Student Marketing Corp., 457 F. Supp. 682, 713 (D.D.C. 1978) (speculating that board might not have violated securities law if attorney had objected). Moreover, an attorney who avoids exercising judgment by attempting to warn clients about every contingency risks finding those warnings ignored when the client should heed them.
The result of such a practice, however, is to undermine the utility of the attorney’s advice to the client, who is left to figure out what warnings to take seriously. About the only thing one could say is that judges (at least in Delaware) have some expertise in providing legal advice to corporate boards. Yet, expertise cannot explain a different standard here. Consider the fact that had the board received poor advice from a professional other than an attorney—such as an opinion on valuation from an investment banker—the standard in a malpractice suit presumably still would not have been the business judgment rule.

If problems of after-the-fact judicial review would not have justified different treatment of the lawyer in Van Gorkom, neither would the nature of the damages or the plaintiff. The damages faced by the attorney presumably would have been the same as faced by the directors he advised. Similarly, if the shareholders of Trans Union sued the attorney, there would be no difference in the plaintiff to explain the different standard applied.

Is there any difference in terms of the economic utility of compensation or deterrence? In a suit against either the directors or the attorney, compensation would come largely from insurance. While the attorney’s policy would not have been purchased directly by the corporation, as were the directors’, the corporation (along with the law firm’s other clients) paid for the attorney’s policy through the fees the attorney charged. In either event, liability for negligence is an expensive way to achieve loss spreading. As far as deterrence is

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175. This fear may, in part, explain why the attorney in Van Gorkom apparently gave the members of the board the unfortunate advice that they might be sued if they voted not to sell.

176. Judges in Delaware, however, might also possess a fair degree of expertise in corporate decisions generally. On the other hand, given the penchant of some governors to appoint trial lawyers, and especially former district attorneys, to the bench, one might question how much expertise some judges have in providing legal advice to corporate boards.


178. Some writers have argued that directors are poorer “loss avoiders” than outside attorneys or accountants because directors do not spread the loss over a large base of clients. E.g., Coffee, supra note 140, at 802. Why this makes any difference is obscure. Cf. Robinson, supra note 112, at 180-82 (challenging the notion that doctors are cheaper loss-avoiders because of their ability to spread costs among their patients). Either director- and officer- or legal-malpractice insurance spreads the loss—albeit in either case through an administratively expensive system. In either case, there is some “social accounting.” The consumers, here the corporations, will pay for the injuries which may occur to themselves by virtue of the legal or managerial services they are buying—either through higher fees to cover the legal-malpractice insurance or by directly paying for the directors’ liability policy. Hence, in both cases liability serves the same
concerned, the attorney, like the directors, faces market incentives. After all, the mergers and acquisitions field is one in which a reputation for good results can dictate economic success for a lawyer.\textsuperscript{179} Conversely, one might suspect boards would be leery of hiring an attorney who previously led his clients into a well publicized fiasco.\textsuperscript{180}

As a second test of these justifications, consider the following hypothetical, somewhat inspired by recent events. Suppose a corporation operates oil tankers. Due to a decision by one of the company’s captains as to speed, course, or whatever, a company ship runs aground, resulting in an oil spill. If coastal-property owners damaged by the spill sue the corporation, the issue will be whether the captain’s decision was negligent.\textsuperscript{181} The corporation would hardly get anywhere by arguing for a “nautical judgment rule” under which it could avoid liability unless the captain acted in bad faith, or with gross rather than ordinary negligence, or which confined the fact finder to focusing exclusively or primarily upon the methodology by which the captain reached the decision rather than upon the decision itself. Moreover, since the corporation’s liability is vicarious, the captain could be personally liable to the damaged coastal property owners for negligence.\textsuperscript{182} The captain, too, would not get far arguing for a different threshold for liability.

Now suppose the corporation sued its captain to indemnify it for the judgment it paid the property owners or even for loss of the ship and cargo. Again, the standard upon which the captain’s liability will hinge is simple negligence.\textsuperscript{183} There appears to be little or no author-

\textsuperscript{179} Just ask Joseph Flom, the noted takeover attorney at Skadden, Arps, Meagher, Slate & Flom.

\textsuperscript{180} The problem is not simply that the directors were liable. Business clients may appreciate attorneys willing to propose an aggressive position to achieve their aims even though there is some risk of liability. Probably no one, however, appreciates being blindsided by facing liability without any warning.

\textsuperscript{181} This assumes that the transport of oil is not an ultra-hazardous activity resulting in strict liability.


\textsuperscript{183} E.g., Fenly v. Revell, 228 P.2d 905 (Kan. 1951); State ex rel. Algiere v. Russell, 223 S.W.2d 481 (Mo. 1949); Darman v. Zilch, 186 A. 21 (R.I. 1936) (holding that an employee is liable to his employer for the employee’s acts of negligence which cause the employer damage, whether the damage is direct or brought about by the compensation the employer must pay to a
ity for applying the business judgment rule to accidents caused by corporate employees below top management.\textsuperscript{184}

To introduce the business judgment rule, let us change the facts of the hypothetical. To keep things simple, assume the grounding was the result of a storm or, in any event, not the result of any person's negligence. Assume also, however, that had the tanker possessed a double hull, it would have survived the grounding without a spill. Further, let us suppose the corporation's board of directors made the decision to purchase single- rather than double-hulled oil tankers. This was a business decision in which the board had to balance the protective advantages of double hulled tankers against their added costs and lower cargo-carrying capabilities. What would the result be if the damaged-coastal-property owners sued the corporation? Again, the standard for liability would be simple negligence, not the business judgment rule.\textsuperscript{185} The same would be true if the damaged property owners sued the directors personally: Courts do not apply the business judgment rule to suits by third parties against directors whose decisions have caused injury.\textsuperscript{186}

\textsuperscript{184} See, e.g., Steffen, supra note 58, at 487 (ordinary employees held to higher standard than directors); Manning, supra note 86, at 652 (business judgment rule is applicable only at the highest corporate level). There is some authority that the business judgment rule may apply to executive officers of the corporation. E.g., Kaplan v. Centex Corp. 284 A.2d 119 (Del. Ch. 1971). This presumably refers to top corporate officers, such as the president, not to ship officers.

\textsuperscript{185} This is the sort of corporate-safety-versus-cost decision toward which Judge Hand directed his formula in United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947).

\textsuperscript{186} E.g., Frances T. v. Village Green Owners Ass'n, 723 P.2d 573, 582-83 (Cal. 1986) (stating that the court was unaware of any case from any jurisdiction in which the business judgment rule governed a director's liability in tort to third persons); Bowes v. Cincinnati Riverfront Coliseum, Inc., 465 N.E.2d 904 (Ohio Ct. App. 1983).

A potential source of confusion when discussing third-party claims against corporate directors comes from the rule that directors generally are not liable to third parties for breaching the duty of care owed to the corporation. E.g., Newman v. Forward Lands, 418 F. Supp. 134, 137 (E.D. Pa. 1976). This is simply part of the rule of agency law that the mere failure to perform an agent's duty to his or her principal does not, except in certain cases, render the agent liable to a third party injured by the neglect. E.g., Restatement (Second) of Agency § 352 (1984). On the other hand, neither directors nor other agents can escape liability for conduct which would otherwise constitute a tort toward a third party just because the director or agent was acting on behalf of the corporation. E.g., Frances T., 723 P.2d at 582-83; Restatement (Second) of Agency §§ 343, 350. Difficulties in reconciling these two propositions occur primarily when the claim involves inaction by the director or agent and economic loss rather than physical injury. See, e.g., Newman, 418 F. Supp. at 136-37; Restatement (Second) of Agency §§ 354, 357.
Now, however, consider what would happen if the corporation sued the directors, either to indemnify it for any payment to the injured property owners or for loss of the ship and cargo. This would seem to call for application of the business judgment rule.\textsuperscript{187} The incongruities are striking. The same board decision about double hulls which a court would have no trouble scrutinizing under an ordinary negligence standard in a suit brought by third parties—either against the corporation or against the directors personally—would suddenly demand the lesser scrutiny of the business judgment rule when the corporation brought the suit. Moreover, any qualms about the corporation suing those acting on its behalf would fade immediately if the suit was against the captain rather than the directors.\textsuperscript{188}

Can any of the proffered justifications possibly explain the distinctions here? Would after-the-fact judicial review of the directors’ decision regarding double hulls present that much greater probability of error or of deterring worthwhile risk taking than would review of the ship captain’s judgment?\textsuperscript{189} Even if so, the difficulties of after-the-fact review cannot explain the different standards applied to the

\textsuperscript{187} Perhaps the normal rule requiring one who is at fault to reimburse the party whose liability is vicarious would apply to the company’s claim for reimbursement of funds paid to the injured property holders. However, this is by no means certain.

\textsuperscript{188} The situation facing the Massachusetts Supreme Court in Uccello v. Gold’N Foods, Inc., 90 N.E.2d 530 (Mass. 1950), came tantalizingly close to creating such a paradox. Uccello, a minority shareholder in Gold’N Foods, sued the directors for mismanagement. Gold’N Foods manufactured salad dressing. Due to use of poor ingredients, Gold’N Foods suffered numerous complaints and returns of spoiled dressing, and ultimately went out of business. The directors knew of the problem but continued manufacturing without solving it. The court applied a gross negligence standard under its interpretation of the business judgment rule and exonerated the directors. Fortunately, the spoilage did not create a health hazard. Had the spoilage done so, then the Massachusetts court would have confronted the situation in which the same board decision would face review under a gross or under an ordinary negligence standard—this case having arisen before strict products liability—depending upon who brought the action. Moreover, had an ordinary employee’s negligence caused the spoilage, the business judgment rule presumably would not apply even to an action by the company against the employee.

\textsuperscript{189} [I]t is a mistake to say that it is only the director who has to make decisions calling for initiative and good judgment. The truck driver on the road, under orders to make a schedule, perhaps furnished with defective equipment, makes more decisions of the kind per mile, than many directors do in a month. Whether or not to pass the car ahead, and thus to forward the employer’s affairs, involves serious business risk, and surely calls for skill and good judgment. Why then does the “law” say that if the driver makes even one mistake, it is at his risk; while any good faith error on the part of a director merely results in a “business” loss?

Steffen, supra note 58, at 487.
double-hull decision depending upon whether the suit is by the injured property owners or by (or on behalf of) the corporation. Clearly, the nature of the damages cannot explain the results: The damages are substantially the same throughout.190

The difference in the nature of the plaintiff might account for the different standards applied to the directors’ decision; but then what about the corporation’s action against the ship captain? Perhaps one might argue that the business judgment rule should insulate all corporate employees from liability for ordinary negligence. Suppose, in that event, the grounding resulted from the decision of a harbor pilot who was working for the company as an independent contractor? Alternately, suppose a partnership or sole proprietorship operated the tanker: Should employees have a different standard of liability depending upon whether they work for a corporation or an unincorporated employer? In short, once one starts suggesting corporations should be unable to sue some of their employees for ordinary negligence, it is difficult to know where to stop.

Finally, what about compensation or deterrence? Putting aside the questions of whether the injured coastal property owners might just as well have purchased insurance for themselves, or whether their need for compensation exists even if the spill was not the result of negligence, it is clear that the corporation’s need for compensation cannot explain the difference in the standard between the corporation’s suit of the ship captain and of the directors. As for deterrence goals, how this distinguishes the appropriate standard for the captain versus the directors is a mystery.191

The bottom line is that utilizing the business judgment rule to insulate directors from liability for ordinary negligence creates differences in treatment between individuals which cannot be explained by any policy justifications. That alone should be enough to condemn this approach. Yet, there are other difficulties with the rule that the following two sections of this Article explore.

190. The damages involve property loss rather than personal injury and are potentially enormous.
191. The captain possesses market incentives for care—he must worry about his job—not to mention incentives based upon his concern for his personal safety.
C. THE IMPACT OF CONFLICTS OF INTEREST

As stated earlier, the business judgment rule only protects directors from liability when their decision does not involve a conflict of interest. This is not to say that directors are automatically liable for any transaction which involves a conflict. Rather, the court reviews such a transaction to see if it is fair to the corporation. Under this fairness test, the defendant must prove that the transaction was one which would have commended itself to a disinterested board. The result of this approach is to divide board decisions into two types: those which involve a conflict of interest and those which do not. Because of the danger that directors will consciously or unconsciously sacrifice corporate interests for their own, courts subject conflict of interest transactions to heightened scrutiny, while using a more relaxed review when directors are disinterested.

One problem with this approach, however, is that it fails to square with the realities of board decision-making. Board decisions often do not fit neatly into the polar model of either interested director transactions or disinterested decisions. Instead, board decisions all too frequently involve “fuzzy” or partial conflicts of interest. Here, the directors do not stand on both sides of a transaction with their company, yet the decision involves personal concerns for the directors which can bias their judgment away from the corporation’s best interest. Two examples, which have been at the hub of much corporate litigation, illustrate the point.

The first example consists of the defenses against hostile takeovers which directors of target companies often employ. Generally, such defenses do not entail transactions between the target corporation and its directors, or between the target and other firms in which the directors have a stake. Accordingly, these defenses do not involve a traditional conflict of interest situation. Because of this, a

192. See supra text accompanying note 18.
194. E.g., Fliegler v. Lawrence, 361 A.2d 218, 225 (Del. 1976); Beard v. Elster, 160 A.2d 731, 737 (Del. 1960); see also PRINCIPLES OF CORPORATE GOVERNANCE, supra note 2, § 5.02(a)(2)(A) cmt. at 289-92 (explaining fairness test).
195. For a description of many of the most common takeover defenses see Gevurtz, supra note 92, at 781-86.
196. Possible exceptions include golden parachutes as well as lockups given to acquiring firms in a management buy-out. See, e.g., Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989).
number of courts have applied the business judgment rule to such defenses.197 Other courts198 and writers199 dissent from this approach. They note the inherent conflict of interest board members face when opposing a hostile takeover which might cost the directors their jobs.200

A second example comes from the phenomenon of boards of directors, or specially appointed committees of boards, moving to dismiss shareholder derivative litigation.201 Many courts have applied the business judgment rule to such motions.202 Yet, a serious question exists as to whether even directors who are not defendants in the derivative action can review free of any conflict the corporation's interest in a suit against fellow directors. A number of courts and writers have outlined the various sources which can produce a "structural bias" in such a situation.203

197. E.g., Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264 (2d Cir. 1986) (but holding that directors' conduct failed on due care grounds); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981), cert. denied, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690 (2d Cir. 1980); cf. Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980) (holding that business judgment rule will not apply if directors' predominant motive was to preserve their control).

198. E.g., Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), rev'd on other grounds, 481 U.S. 69 (1987); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 271 (2d Cir. 1984); Heckmann v. Ahmanson, 214 Cal. Rptr. 177 (Ct. App. 1985).


Directors of a New York Stock Exchange-listed company are, at the very least, “interested” in their own positions of power, prestige and prominence (and in their not inconsequential perquisites). They are “interested” in defending against outside attack the management which they have, in fact, installed or maintained in power—“their” management (to which, in many cases, they owe their directorships). And they are “interested” in maintaining the public reputation of their own leadership and stewardship against the claims of “raiders” who say that they can do better.

Id. at 300-01 (Cudahy, J., concurring in part and dissenting in part) (footnote omitted). The flip concern may exist when directors will retain positions in a merged corporation, thereby giving the directors personal incentives to approve a merger. See, e.g., Security Trust Co. v. Dabney, 372 S.W.2d 401 (Ky. 1963) (rejecting the argument that this incentive created a conflict of interest).


203. E.g., Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (**We must be mindful that directors...
While these two examples have provoked the most litigation and commentary in the last couple of decades, they by no means exhaust the fuzzy conflict of interest problem. Rather, they are simply variants on several broader conflict of interest situations. If the directors' concerns about their jobs make one suspicious of their disinterest in considering takeover defenses, what about transactions which involve controlling or even major shareholders? This includes both parent-subsidiary dealings, as well as transactions with individuals having large stockholdings. For example, the Aronson v. Lewis decision mentioned previously\(^{204}\) involved a consulting contract Meyers Parking System, Inc. made with an individual owning forty-seven percent of its shares.\(^{205}\) A director concerned about remaining with the corporation's board is going to have a difficult time voting against a transaction desired by a controlling shareholder.

Alternately, once one accepts the notion that structural bias may undermine the disinterest of board members weighing litigation against fellow directors, then one starts to question how objective directors can be in any decision in which other board members have a stake.\(^{206}\) The presumption behind most corporation statutes dealing with conflict of interest situations is that the directors not transacting business with the corporation can look out for the corporation's best interests. This is implicit in the statutes' establishing approval by disinterested directors as an alternative to proving fairness in order to validate a transaction in which some directors have an interest.\(^{207}\) Yet, this presumption may be at odds with the practical and psychological realities of board decisionmaking.\(^{208}\)

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\(^{204}\) Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

\(^{205}\) Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971) (involving a transaction with a family owning 40 percent of the corporation's stock).

\(^{206}\) Coffee & Schwartz, supra note 128, at 283 (arguing that structural bias is a worse problem when reviewing a derivative suit against a fellow director).

\(^{207}\) Myles M. Mack, Directors: Myth & Reality (1971); Principles of Corporate Governance, supra note 2, § 5.02(a)(2)(B) cmt. at 203; Victor Brudney, The Independent
Faced with these examples, one could argue about where courts should draw the line between business judgment and fairness review. Recognizing conflicts of interest beyond the traditional transaction in which the director stands at both ends, however, potentially opens the door to fairness review of a myriad of board decisions. For example, is there a conflict of interest when a bank loans money to a developer who employs the son of the bank’s president? What if the son worked only in a summer job? What if the employee was a nephew? What if the developer was simply a friend of the chairman? In short, conflicts of interest are not the rare and easily defined exception, but instead constitute a hazy background pervading much of corporate decisionmaking.

This problem, in turn, impacts the choice of the duty of care standard under the business judgment rule. If courts apply a standard of ordinary negligence to nominally disinterested transactions, there will be some gap between the fairness and duty of care standards, at least because the burden of proof will be on different sides. Nevertheless, there will be a review of the objective reasonableness of a transaction even if the court finds no conflict of interest. Hence, there will be some check on the directors making poor decisions due to the influence of these partial conflicts of interest, without creating the burden which would result if every conceivable conflict of interest resulted in a full-blown fairness review. If courts, however, utilize the business


209. E.g., Arsh, supra note 25, at 116-17; Manning, supra note 86, at 618.


Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, or, as is here alleged, shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation.

The latest version of the M.B.C.A. attempts to square the circle in this area. While recognizing the potential for “countless relationships and linkages,” the Model Act offers an exclusive definition of conflicting interests. M.B.C.A. § 8.60 cmt.

212. See Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981) (arguing that the business judgment rule is based on the recognition that all director decisions involve some personal interest but it would be impractical to take this into account).

213. See supra text accompanying notes 80-81.
judgment rule to insulate directors from liability for ordinary negligence, then the gap between the fairness test and the standard applicable to nominally disinterested transactions widens considerably. Accordingly, interpreting the business judgment rule to require a showing of gross negligence for liability, to lessen the court’s ability to review the substance of a decision as opposed to the process used to reach it, or to preclude any review other than as to subjective good faith, increases the stakes placed upon the initial determination of whether the directors are disinterested. Given the prevalence of fuzzy conflict of interest situations, increasing the stakes in this manner would move things in the wrong direction.

Litwin v. Allen\textsuperscript{214} provides a good illustration of this point. As noted earlier,\textsuperscript{215} Litwin is one of the most often cited cases applying an ordinary negligence standard to find directors liable for a business decision. Some writers have sought to explain the result in Litwin by pointing out that the case involved something of a conflict of interest.\textsuperscript{216} Specifically, Morgan Stanley owned a substantial block of stock in both Guaranty Trust and indirectly in the firm which sold Guaranty Trust the debentures. By using a standard which allowed it to review the objective reasonableness of the debenture purchase, the court was able to avoid having the case turn on the question of whether to apply a fairness review.

D. The Judicially Created Business Judgment Rule in an Area of Statutory Law

Another difficulty raised by using the business judgment rule to alter the appropriate standard for duty of care liability is how this will coordinate with various state corporations statutes. There are two types of problems to consider here. The first concerned the drafters of the Revised Model Business Corporation Act. Section 8.30 sets out a statutory standard for the directors’ duty of care. This requires a director to act “with the care an ordinarily prudent person in a like position would exercise under similar circumstances” and “in a manner he reasonably believes to be in the best interests of the corporation.”\textsuperscript{217} Numerous state corporations statutes contain similar

\begin{footnotesize}
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\item \textsuperscript{214} 25 N.Y.S.2d 667 (Sup. Ct. 1940).
\item \textsuperscript{215} See supra text accompanying note 27.
\item \textsuperscript{216} E.g., Clark, supra note 15, at 127.
\item \textsuperscript{217} M.B.C.A. § 8.30(a).
\end{itemize}
\end{footnotesize}
language. The problem is that such language, to the common law­
der's understanding, is synonymous with the standard for ordinary
ingen. This creates an apparent conflict when courts apply the
business judgment rule to preclude director liability for ordinary

Those who would use the business judgment rule to insulate
directors from liability for ordinary negligence have dealt with this
seeming contradiction in a couple of ways (other than just by ignoring
it). One way is to interpret the statutes as imposing a lower duty on
directors. For example, some judicial decisions have viewed stat­
utes which speak of the care of an ordinary prudent person “in similar
circumstances” not to create the same duty of ordinary care which the
statute would if it spoke of an ordinary prudent person “in his own

The notion appears to be the rather strange one that the
ordinary prudent person should be less careful with other people's
money than with his or her own. More fundamentally, to view the “in
similar circumstances” language as somehow abrogating an ordinary
negligence standard ignores the fact that such language is an integral
part of the reasonable person test, not a contradiction of it. Presumably for these reasons, few, if any, recent decisions rely on this
distinction.

218. E.g., 2 MODEL BUS. CORP. ACT ANN. § 8.30, at 934-37 (3d ed. 1990) (listing over 34
state statutes containing provisions similar to section 8.30 of the Model Act).

219. E.g., Arslan and Hinesey, supra note 11, at 951; Dyson, supra note 37, at 371, 375; Veasey
& Manning, supra note 11, at 927.


222. E.g., Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1151 (5th Cir.
1989) (interpreting the statute at issue to require gross negligence).

223. E.g., Keeton et al., supra note 57, at 175.

circumstances” language to create liability for ordinary negligence); Veasey & Manning, supra
note 11, at 926-27 n.36 (stating that Selheimer represents the rare, if not the only, case where this
distinction has been determinative of the outcome). A more recent effort to interpret statutory
duty of care provisions to impose a lower standard for directors than the common law of torts is
found in Justice Mosk's dissenting opinion in Frances T. v. Village Green Owners Ass'n, 723
P.2d 573 (Cal. 1986). The majority in Frances T. held the directors of a condominium association
liable for ordinary negligence to a third party injured by their refusal to install adequate lighting.
In dissent, Justice Mosk argued that the standard in the corporations code supplanted the
common law of negligence even as to claims by third parties. Id. at 595 (Mosk, J., dissenting). He
further argued that the statute adopted a “somewhat lower” standard than the common law of
negligence, the statutory standard being one of “subjective reasonableness.” Id. at 596. He
based this conclusion on three portions of the statute. Id. at 597. To begin with, the statute
requires directors to act in good faith. This, however, hardly suggests a lower standard of care
since the good faith language is part of a conjunctive test with the prudent person language.
This has led to the alternate approach alluded to in the Official Comment to section 8.30 of the Model Business Corporation Act. The notion is that the corporations statute sets out the directors' duty of care, but does not address what impact breach of this duty will create. For example, section 8.30(d) states that directors who meet the standard of care cannot be liable, but section 8.30 does not state what happens if directors do not fulfill their duty. This omission in turn, the argument runs, allows the courts to decide the rules for imposing liability. Hence, the courts can apply a business judgment rule that insulates directors from liability despite the directors' having fallen below the statutory mandate of reasonable care. As the Official Comment to section 8.30 explains:

If compliance with the standard of conduct set forth in former section 35 or section 8.30 is established, there is no need to consider possible application of the business judgment rule. The possible application of the business judgment rule need only be considered if compliance with the standard of conduct set forth in former section 35 or section 8.30 is not established.

It is, of course, possible for legislatures to enact statutes setting out the duties of corporate directors with the expectation that courts will refuse to impose liability on directors who fail to carry out those duties. This would seem to be a rather queer and pointless exercise, however. Accordingly, this approach is not persuasive.

Recently enacted provisions in many states seeking to protect directors from duty of care liability present a different concern. A
A growing number of states have enacted protective legislation in reaction to a perceived crisis triggered by the *Smith v. Van Gorkom* decision. These statutes fall into two broad camps relevant here. The more common type allows individual corporations to change the rules of liability by placing provisions in the company's articles which limit the exposure of that firm's directors. The other type changes the grounds for director liability for all firms incorporated in the state. For example, the Virginia legislature has reduced the duty of care for directors of Virginia corporations to merely require the exercise of the director's good faith judgment.

A detailed critique of such legislation is beyond the scope of this Article. The general themes developed here, however, suggest a couple of broad comments. Provisions in the certificate of incorporation limiting director liability for negligence present the same fundamental issue as contractual waivers of negligence liability in other contexts. That issue is the need to reconcile the goal of allowing individuals to adjust their relationships to suit themselves by contract with the concern that individuals not lose protection against negligent injury as a result of economic coercion or the failure to fully appreciate the impact of what they are doing. While the basic issue is the same when dealing with different groups of prospective defendants, the resolution need not be. On the contrary, the prospect for waiver by coercion or confusion may depend upon the specific context.

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227. 488 A.2d 858 (Del. 1985).
228. A number of states have amended their corporations statutes to specify that directors may, consistent with their duty of care, consider the interests of employees, creditors, the community and others in making decisions for the corporation. *E.g., Minn. Stat. Ann. § 302A.251(5) (West 1992); N.J. Rev. Stat. § 14A:6-14(4) (1992); Ohio Rev. Code Ann. § 1701.39(E) (Baldwin 1993); 15 Pa. Cons. Stat. § 1715 (1992).* This, however, does not alter the level of care expected of directors; it simply expands the scope of permissible (or even mandatory) factors the directors can consider in exercising their care.
230. *Va. Code Ann. § 13.1-690(A) (Michie 1992); see also Ind. Code Ann. § 23-1-5-1(e) (West 1992) (stating that directors are liable only for willful misconduct or recklessness).*
232. *E.g., Tunkl, 393 P.2d at 445-46 (outlining six factors largely going to the bargaining power of the parties for determining if an exculpatory contract violates public policy); Allright, Inc. v. Schroeder, 551 S.W.2d 745 (Tex. Civ. App. 1977) (not enforcing an exculpatory clause written in fine print on a claim ticket).*
233. In fact, courts have traditionally enforced exculpatory clauses for some categories of defendants but not for other categories. *E.g., Keeton et al., supra note 57, at 482-83; see also*
processes of shareholder voting and purchasing decisions—a subject about which much has been written.234 Whatever the appropriate balance here, there is no logical reason it need be the same as when dealing with, say, waivers by those seeking emergency medical care (when the prospects for coercion are of a different order of magnitude). Accordingly, if a legislature decides to allow liability waivers in articles of incorporation, this is not necessarily creating an unjustified differentiation in the treatment of corporate directors. Indeed, to the extent courts generally uphold liability waivers in employment contracts,235 such legislation actually serves to correlate the treatment of directors with that of other agents.

Unfortunately, similar kinds remarks cannot be made about those statutory provisions which automatically limit director liability for all corporations in a jurisdiction. Such provisions are symptomatic of the ad hoc approach to tort law reform under which various groups of prospective defendants—doctors, directors or whoever—lobby the legislature for special treatment. If, as suggested above, the possible problems created by director liability for ordinary negligence parallel the problems of negligence liability for many other groups, any legislative action should deal with the issues across the board.

III. CONCLUSION

The obstetrician dealing with a difficult labor, the trial lawyer planning strategy, or just the automobile driver attempting a left turn into a busy thoroughfare must exercise judgment. So must we all. When this judgment results in harm to another, then the doctor, attorney, or driver can find him or herself as the defendant in a suit based upon negligence. Perhaps this has produced a system in which there is too much second guessing by those who have the benefit of twenty-twenty hindsight. Perhaps an unintended effect of this Article will be to add to the debate over tort law reform. Be that as it may, there is simply no call for treating business judgments by corporate directors any differently than any other judgment. Where then does this leave the business judgment rule? Evidently, it is a phrase of limited utility

N.Y. GEN. OBLIG. LAW §§ 5-321 to 5-326 (McKinney 1992) (listing activities in which exculpatory clauses are contrary to public policy).
234. For a sampling of this literature see Symposium, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395 (1989).
and much potential for mischief. Accordingly, the business judgment “rule” is a rule which corporate law would well do without.